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Barbarians at the vault
Western finance is under attack. Yet the banking system has done much better than it is given credit for: leader

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Politics this week

May 15th 2008
From The Economist print edition

Reuters

China suffered its biggest natural disaster for 30 years when an earthquake devastated Sichuan province killing some 50,000 people, according to official estimates. President Hu Jintao ordered an all-out rescue effort and the prime minister, Wen Jiabao, flew to the region to supervise it. See article

In contrast, **Myanmar's** military regime continued to let in only dribbles of aid to the cyclone-ravaged country, where the estimated death toll rose to 130,000. The government resisted pleas from many quarters for it to open up. Meanwhile, the regime said more than 92% of voters had backed a new draft constitution in a referendum. Critics say it is a sham. See article

Several bombs were set off in the Indian city of **Jaipur**, killing at least 61 people and injuring more than 200. A little-known group, Indian Mujahideen, claimed responsibility. See article

Pakistan's coalition government fell apart, with Nawaz Sharif's party pulling out of its partnership with Asif Zardari's party in Islamabad. See article

Japan's prime minister, Yasuo Fukuda, pushed a controversial road-construction bill through the lower house of parliament, overruling an opposition vote in the upper house. It is the last big piece of legislation in this session of the Diet (parliament). Mr Fukuda is likely to survive as prime minister for the G8 summit this summer, but another clash with the opposition and critics in his own party is expected this autumn.

A shocking war on drugs

Another senior policeman was shot dead by gunmen associated with drug-trafficking gangs in **Mexico**, bringing the number of high-ranking officers that have been assassinated recently to four. More troops were deployed to fight drug-related violence, which has resulted in more than 1,000 deaths this year. See article

Colombia extradited 14 paramilitary warlords on drug-trafficking charges to the United States, where they could face 30 years or more in prison. President Álvaro Uribe said they had broken the terms of a deal with his government under which they would have received a maximum eight-year sentence. See article

A computer hacker published on the internet confidential records belonging to 6m Chileans, including their ID-card numbers, academic records and telephone numbers. He said his aim was to demonstrate **Chile's** poor level of data protection.

Bolivia's president, Evo Morales, set August 10th as the date for a referendum that will decide whether he and the country's regional governors should remain in office. He is embroiled in a battle with the governors over his plans for constitutional reform.

Fans of the European Union

Reuters

Pro-European parties did unexpectedly well in **Serbia's** general election, suggesting that voters may care more about getting into the EU than about losing Kosovo. But coalition-building will take several weeks, and it is possible that the nationalists may yet scrape together a government. See article

A new **Russian government** was announced by Vladimir Putin, the prime minister. Mr Putin continues to overshadow his successor as president, Dmitry Medvedev. See article

One policeman was killed and four people were injured when a car bomb went off in the **Basque country** in Spain. The Basque separatist group, ETA, was assumed to be responsible. See article

In a huge U-turn, Gordon Brown, **Britain's** embattled prime minister, cut income tax for 20m people to fend off a backbench revolt over the scrapping of a lower 10p rate. Mr Brown also set out his legislative programme, but against the backdrop of a weakening economy. See article

The potential for violence

Lebanon was racked by fighting across the country after its beleaguered pro-Western government tried to sack the head of airport security and to dismantle the communications network of Hizbullah, a Shia party-cum-militia. Hizbullah reacted by briefly capturing the centre of Beirut, the capital, and the television station of the main Sunni party. The Saudi foreign minister accused Iran, which helps Hizbullah, of “backing a coup”. See article

A motorised rebel force more than 1,000-strong from **Sudan's** troubled Darfur region, apparently backed by neighbouring **Chad**, was fended off after attacking Omdurman, a suburb of Sudan's capital, Khartoum, shocking the government with its audacity. See article

The leader of **Zimbabwe's** opposition, Morgan Tsvangirai, who was officially acknowledged to have defeated President Robert Mugabe in the first round of a presidential poll in March, agreed to come back from abroad and compete in a run-off, even though he insists that he won the first round outright. The electoral commission said the next round may not be held until the end of July. See article

George Bush visited **Israel** to celebrate its 60th anniversary. He said he would not conduct any peace-seeking diplomacy while there, but he praised the prime minister, Ehud Olmert, as “an honest guy”. A few days before, Israeli police renewed an investigation into allegations that Mr Olmert had taken bribes when he was previously mayor of Jerusalem and a minister.

AFP

So much for wearing a flag pin

As expected, Hillary Clinton won the Democratic primary in **West Virginia** by a whopping margin, 67% to 26%, underlining Barack Obama's lack of support among blue-collar voters. But the party began to unite behind Mr Obama and he secured the endorsement of John Edwards, who pulled out of the presidential race in January. See article

John McCain was also out on the trail. He made a big speech on climate change and called for limits on America's greenhouse-gas emissions, putting more distance between himself and George Bush. See article

The **Republicans** lost another congressional seat in a special election, this time in north Mississippi. The party had made every effort to stop the district from falling to the Democrats, including flying in Dick Cheney to stump for their candidate. The Republicans have lost three seats so far this year to the Democrats in once-solid “red” districts.

America's interior secretary designated the **polar bear** a threatened species because of the reduction in Arctic sea ice, its primary habitat. The decision might also hamper oil drilling in the Arctic.

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Business this week

May 15th 2008
From The Economist print edition

Hewlett-Packard launched its biggest acquisition since its 2002 takeover of Compaq, when it agreed to buy **Electronic Data Systems**. The deal is valued at $13.9 billion. HP hopes its new purchase will enable it to compete better with IBM in a broad range of computer services. Investors are not so sure. HP's share price fell by 10% on news of the deal, knocking $12 billion off its stockmarket value. See article

It emerged that **General Electric** is thinking about selling its appliances division, which has been supplying homes with refrigerators, air conditioners and the like for decades. The conglomerate is under pressure to improve returns to shareholders and the division is now a relatively small part of its business.

Among the week's list of casualties in the subprime-loans crisis, **MBIA**, the world's largest bond insurer, reported a $2.4 billion quarterly loss and took write-downs of $3.6 billion; **Crédit Agricole**, a French bank, launched a *euro*5.9 billion ($9.1 billion) rights issue to offset mounting losses at Calyon, its investment-banking unit; and **Freddie Mac**, a government-backed housing-finance company, posted its third consecutive quarterly loss and unveiled a plan to raise $5.5 billion in new capital.

Property crash

The slump in **American house prices** will continue until at least next year, according to **HSBC**, which holds a sizeable portfolio of subprime loans and is thus seen as a good guide to where the market is heading.

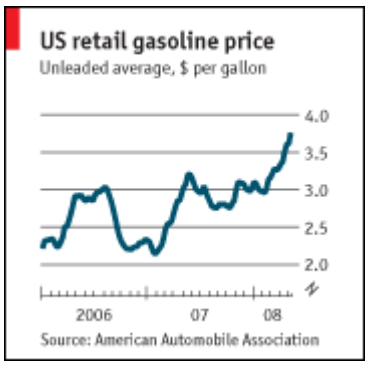
In a deal that creates Australia's largest bank by market value, **Westpac** agreed to merge with **St George**, paying A$18.6 billion ($17.5 billion) for its smaller rival.

The decision by **Yahoo!** to reject Microsoft's takeover offer led to more grumbles from shareholders. But they took heart at the news that **Carl Icahn**, a veteran activist investor, has bought a stake in Yahoo! and will press the company to return to the negotiating table.

Cablevision, a cable-TV operator, won the bidding for ***Newsday***, a newspaper based in New York's Long Island suburbs, with an offer worth $632m. The sale represents a defeat for Rupert Murdoch's News Corporation, which wanted to combine the distribution operations of its *New York Post* with *Newsday*'s.

On the road

With the price of oil hurtling towards $130 a barrel, the **cost of petrol** in America crept ever higher just before the start of the summer driving season, which begins on Memorial Day (the last Monday in May). Meanwhile, the International Energy Agency again cut its forecast for the growth in demand for oil this year, causing analysts to ponder whether rising oil prices would cause global energy consumption to fall. See article



Canada's biggest energy company decided to split into two separately traded enterprises to take advantage of the high oil price. **EnCana** is hiving off its oilsands and refinery operations, which account for a third of its current assets, from its natural-gas business.

Nissan forecast that its profit for the 12 months ending March 31st 2009 will fall by around 30% because of higher material costs, a stronger yen and the slowdown in America. Other Asian carmakers have produced similar gloomy outlooks.

Airline wait times

A delay to the “ramped-up” production of Airbus's A380 was announced. EADS, Airbus's parent company, confirmed that five super-jumbos would not be ready for delivery as promised this year and next. After previous delays because of manufacturing woes, the A380 finally entered commercial service last year.

China established a state corporation to build commercial jets. With an expanding domestic market, the government wants to lessen its reliance on Airbus and Boeing with **Chinese-made aeroplanes**, but observers remain sceptical that China can compete globally. See article

Finmeccanica, a defence company in which the Italian state holds a 34% stake, boosted its presence in the American market by agreeing to acquire **DRSTechnologies** for $5.2 billion. DRS makes night-vision equipment, among other things, and is part of a team led by Boeing working on border security with the Department of Homeland Security.

BAA said that the managing director of Heathrow would step down from his job. Mark Bullock was responsible for the integration of the airport's **Terminal 5**, which endured a chaotic opening that led to hundreds of flight cancellations. His replacement is Mike Brown, chief operating officer of London Underground, another organisation in which passengers have a few quibbles about the service.

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KAL's cartoon

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Illustration by Kevin Kallaugher

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Banks

Barbarians at the vault

May 15th 2008
From The Economist print edition

Modern finance is under attack. Yet the banking system has done much better than it is given credit for

BANKS have endured a brutal nine months since credit markets froze in August. Losses and write-downs already total $335 billion; many of their best businesses have disappeared. In developed economies, almost all banks are facing economic and regulatory headwinds that will cut revenues and jobs. Yet the biggest danger facing Western finance is not a fall in its earning power but a loss of faith in how it works.

Two criticisms assail the industry, one based on fairness and the other on efficiency. The first argues that finance is rigged to enrich bankers, rather than their customers, shareholders or the economy at large. Some worry about the way bonuses are calculated; others about moral hazard. Bankers will take wild bets because they know they will be bailed out by the taxpayer. Look at Bear Stearns or Northern Rock.

The second, deeper question is whether a market-based approach to finance is efficient. Some Chinese officials claim the Western system has been shown up by the crisis (see article). This week Germany's president demanded that the “monster” of financial markets “be put back in its place”: bankers had caused a “massive destruction of assets”. The critics do not lack ammunition. The lapses in credit-underwriting in the subprime-mortgage market hardly reflect a wise allocation of capital. The opacity of the shadow banking system and the mind-boggling complexity of those toxic asset-backed products have raised doubts about the discipline of the market.

Forever blowing bubbles

Be careful. It is not just that a rush to regulate is seldom wise: witness Sarbanes-Oxley, the governance act hurried through in the wake of the corporate scandals earlier this decade. The current assault is dangerous because it mixes a number of small truths with a big, alluring myth. The fiddly verities concern the ways in which finance can indeed be made a bit more efficient or fairer. But you can make those changes only if you dismiss the myth: that finance can somehow be stripped of its failures and perfected. Bubbles, excess and calamity are part of the package of Western finance. And still it is worth it.

Some change is desirable and inevitable. Most of it will be supplied, belatedly, by the market itself—especially if it is bathed in the cleansing sunlight of transparency. America's mortgage business is already transformed. Hundreds of unregulated lenders have disappeared, as has the fatally lazy assumption that house prices do not fall. Demand for complex securitised products has shrivelled and the most complex may never come back. The safest forecast in banking is that the next crisis will not be rooted in

America's mortgage market.

Regulators also have lessons to learn. Most of them come in two categories. The first is to take a broader view of risk. That means looking at off-balance-sheet assets and at gross exposures (Jérôme Kerviel, accused of losing Société Générale $7.2 billion, went unnoticed because managers were watching only his net positions). For national supervisors, it requires a lead regulator with a remit to watch the system. Internationally, the global capital markets would ideally have global regulatory norms—or at least more co-operation between national authorities. Now that the investment banks know the central banks will stand behind them, they also need closer scrutiny and higher capital standards. For the moment supervisors need monitor only what banks lend hedge funds, but you could imagine some hedge funds becoming so central to the system that they too need direct attention.

The second change in philosophy is to bully banks to build buffers when times are good so they have stronger defences when times are bad. The system has come to amplify the extremes of the cycle. Fair-value accounting, which pegs assets to current market prices rather than their historic value, leads to downward (and upward) spirals in asset prices, and hence leverage. Banks' risk models have been backward-looking, so no time appeared safer than the moment before the bubble burst. Working out when an asset boom has become a bubble is not easy—just as it is hard to use monetary policy to lean against asset-price bubbles. But rapid growth, whether in asset prices or market share, should be a signal to worry, not relax. And if banks are to be subject to the firmer discipline of fair-value accounting, it makes sense to have extra padding.

These changes would certainly come at a cost—which is one reason to weigh them more carefully than the framers of Sarbanes-Oxley did. They would have the effect of increasing the amount of capital and liquidity that banks set aside when risks are building, and reducing the amount of leverage they can take on. That would reduce the size and capacity of the industry, although not the size of individual institutions: one result of the crisis is that universal banks are likely to become even more hulking as they seek the benefits of diversification.

On balance, these costs are worth paying to make finance a little safer. Other reforms don't pass that test. For instance, limiting pay or forcing bankers to take equity stakes in their business will not stop moral hazard: Bear Stearns had high levels of employee share-ownership and it did not know it would be able to call on the Federal Reserve. Indeed, whatever you do, finance will not be “fixed” in the way critics are demanding.

Rome or the barbarians: your choice

As this week's special report on international banking makes clear, the main structural causes of trouble—the collective misjudgment of risk; a zealous search for yield; and the failure of oversight—are deep-seated. In financial history they crop up time after time. Financiers are rightly rewarded for taking risks, which by their nature cannot be entirely managed away or anticipated. The tendency for success to breed complacency and recklessness is as ingrained in financial markets as it is in any other walk of life. However bankers are paid, they cannot just sit out a credit boom; they have to keep dancing. Regulators lack the knowledge, the clout (and often the talent) to keep up with the banks' next brilliant scheme.

That reads like an indictment, until you consider the alternatives. Western finance, to paraphrase Churchill, is the worst way to allocate capital, except for all those other forms. It is obviously better than the waste and dysfunction in China, where centrally planned capital is dished out to the well-connected. But it is also better than the financial system the West used to have. Thanks to the astonishing innovation of the past few decades, derivatives can help firms and investors to hedge risks (there are plenty of Chinese manufacturers who would be grateful for an easy way to soften the impact of exchange-rate shifts). Securitisation widens access to capital for borrowers and to assets for investors: it can finance everything from water utilities to film studios. Leverage brings more lazy companies within reach of determined investors and more homes within reach of poorer consumers.

It is true that financiers have enjoyed vast profits—and the vast salaries that go along with them (pay at American investment banks has been nearly ten times the national average). But the collapse of the credit bubble will bring that down. And despite all the disasters, there are signs of finance's resilience. In the past few months the banks have commanded enough confidence to raise $200 billion in new capital from investors. Bear Stearns and Northern Rock were calamities, but rare ones, because the vast overall losses were spread far and wide. This time, there has been no industry-wide government recapitalisation. After 20 years of growth, the flaws of modern finance are painfully clear. Do not forget its strengths.

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Lebanon

Keep it together

May 15th 2008
From The Economist print edition

Lebanon's problems reflect those of the wider region. They must be tackled all the same

AP

IT IS tempting to conclude that Lebanon never was, and never will be, a real country whose inhabitants have an overarching loyalty to their state. Historians have argued, with some cogency, that its inhabitants would have had a better chance of living in peace had it been incorporated into a Greater Syria, when the Ottoman empire collapsed at the end of the first world war. Being parts of a larger whole might—but only might—have given the Christians and Druze and perhaps even the Shia Muslims a good slice of autonomy in the areas where they predominate.

But all that is academic. In the past few months, and especially in the past week, Lebanon has looked even less like a real country. It has had no president since November: the parliament is too divided to elect a new one. The opposition, led by the Shias' party-cum-militia, Hizbullah, refuses to co-operate until it wins a right of veto over parliamentary legislation and over the make-up of the cabinet. Last week, after the Sunni-led government tried to sack a Hizbullah man who had been running security at the national airport and tried to dismantle Hizbullah's communications network, the Shia militia briefly took over the very centre of Beirut, the capital (see article). In the fighting that ensued, Hizbullah, which retains its weapons under a special deal on the grounds that it needs them to keep out the Israelis, turned its guns instead on its fellow Lebanese. It rapidly showed it had more clout than Lebanon's national army, a fragile confection often vaunted as the country's sole unifying institution.

Lebanon has not always looked this hopeless. When things have gone well, it has been hailed as a rare example of a multi-sectarian state—a place where everyone enjoys a cosmopolitan, entrepreneurial and mutual tolerance, as opposed to the dead-handed, centralised authoritarian power that is the Arab norm. This hopeful version of Lebanon seemed briefly plausible three years ago, when neighbouring big-brother Syria, which had ruled the roost since the country's last full-scale civil war ended in 1990, was chucked out amid clamorous hopes that members of all 18 of the country's recognised religious denominations would come together in national harmony. That never really happened. This latest bout of sectarian violence raises doubts that it ever will. Yet there is no serious alternative to trying to make Lebanon stick together.

In many respects, Lebanon reflects the fissures and rivalries that have rocked the wider region. Indeed, that is just the trouble. Since the Shias of Iraq and Iran have come more boisterously to the fore in the past few years, their co-religionists in Lebanon have demanded, ever more insistently, a leading, even predominant, role in their own patch and beyond, in keeping with their fast-growing numbers (they are now Lebanon's largest single group) and in view of their past poverty and political inferiority. Moreover, their backers in the region, especially Iran but also Syria, see Hizbullah as their sharp-nailed cat's-paw at

the eastern end of the Mediterranean, just to the north of their enemy, Israel.

Better than guns for the few

This makes the region's Sunnis, as well as Jews, twitchy. This week Saudi Arabia's foreign minister, using exceptionally fierce language, accused Iran of “backing a coup” in Lebanon. For its part, Israel is rattled by the growing strength of Hizbullah, which it signally failed to defeat in a woefully ill-advised war two years ago, at the same time as a Sunni Islamist movement, Hamas (also backed by Syria and Iran), controls the Gaza Strip just to Israel's south.

It is not just the Lebanese who will suffer if their country is a cockpit for regional proxies. This week the Qataris, who manage to be among the best friends of America in the Gulf while hosting the Arabist al-Jazeera television network, offered to convene a regional conference to calm Lebanon down. Its problems would be easier to settle if the Israel-Palestine conflict were on the way to solution too, since a proper peace between Israel and Syria, which is surely obtainable, would draw much poison out of Lebanon's festering sore.

Lebanon also needs a new constitution and a new electoral law. Ideally, its parliament should be elected to reflect more accurately the country's demography, perhaps with a Senate constituted by a special formula ensuring that all sects have a say and none can ride roughshod. The Shias led by Hizbullah may emerge as the strongest single group. But if Lebanon is to hold together as a country in more than name, Hizbullah cannot continue to rule a separate state within a bogus state.

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Georgia and Russia

Gather round the gorge

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The outside world can help deter both Russian bullying and Georgian vote-rigging

IF YOU have not heard of the Kodori Gorge, you may soon. A Georgian-controlled sliver of territory in the breakaway enclave of Abkhazia, it looks nastily like the flashpoint for a new hot war in the Caucasus. Russia, which protects the Abkhaz regime, insists that Georgia is planning to use Kodori to attack Abkhazia. That is unlikely. Georgia's modern but small army is no match for the Russian behemoth. Steep terrain with only one tiny road divides Kodori from the rest of Abkhazia. And starting a war would ruin Georgia's hopes of joining NATO.

A more plausible explanation of Russia's propaganda offensive and increase in the numbers of both regular and irregular forces in Abkhazia is not fear of a Georgian attack, but plans for the opposite: an attempt to retake the Kodori Gorge. This would humiliate, perhaps topple, Georgia's pro-Western president, Mikheil Saakashvili. Russia would see it as giving a firm response to the deplorable precedent of Western recognition of Kosovo's independence. If you use your muscle to separate Kosovo from Serbia, the Kremlin would grunt, then just watch what we can do to a would-be ally of yours.

Tensions are still growing ahead of Georgia's parliamentary elections on May 21st. A war would splinter Georgia's fragile democracy, destabilise the whole Caucasus and embolden Russian hawks to cause bother elsewhere. That is trouble worth avoiding.

If Russia's new president, Dmitry Medvedev (see article), wants to be taken seriously as more than a puppet of his predecessor, Vladimir Putin, he could start by cooling the row with Georgia. Menacing the country mocks his talk of the rule of law. Others can also help. Some European Union countries are joining Lithuania's hitherto lonely protests on Georgia's behalf. This week five foreign ministers went to Georgia to bemoan Russia's knout-rattling. A mission of foreign military and political observers to the Kodori Gorge itself would be a useful follow-up. It would give the lie to Russia's claims that Georgia is preparing for war. And it could deter Russia from an attack. Killing Georgian soldiers is one thing for Russia; killing officials from EU and NATO countries is another.

Georgia should change too

Meanwhile Georgia could help itself by bolstering its democratic credentials. The heavy-handed dispersal of street protests in November and allegations of ballot-rigging in January's presidential election have sullied its reputation. That helped NATO's summit in April decide that putting Georgia on a clear track to membership was premature.

Georgia's friends might rally more enthusiastically behind it if the parliamentary elections were not just clean, but seen to be beyond reproach. Mr Saakashvili's supporters say that the opposition is intransigent and maybe even outright treacherous. Bits of it may well be. But that is no excuse for dodgy election practices.

It is sadly too late to settle some controversies, such as the composition of the election commission. But video recordings of the numbers entering polling booths should be comprehensive and freely available to help allay suspicions of ballot-stuffing. Complaints need to be followed up seriously. Otherwise the impression given is one of arrogance at best, and at worst a willingness to conceal dirty deeds. Outside monitors should offer to look into any complaints that the Georgian authorities fail to investigate properly.

Demonstratively coupling its prosperity with freedom and legality will win Georgia moral high ground, and wider backing, in its war of words with Russia. And it might one day even help win back Abkhazia too.

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Disasters in China and Myanmar

No time to sit back

May 15th 2008
From The Economist print edition

China has shown up Myanmar's generals. But it is not too late for outsiders to help the Burmese

Eyevine

Get article background

IT HAS taken another catastrophe, this one in China, to show the generals who run Myanmar how better to respond to a natural disaster. Ten days after a cyclone struck Myanmar (formerly Burma) on May 2nd, the xenophobic junta there had managed to ensure that aid from abroad was still only trickling in and most of what had arrived was not being distributed to those who needed it. The United Nations' estimates for the dead and vulnerable were rising dramatically. It was then that a devastating earthquake struck western China. President Hu Jintao at once mobilised soldiers and other workers in an all-out rescue effort. The prime minister, Wen Jiabao, arrived in the region within a few hours, making no attempt to play down this “severe disaster” and saying China would gratefully accept international help (see article). The contrast with Myanmar was telling.

So was the contrast with the China of 1976, when an even deadlier earthquake struck the city of Tangshan. The full awfulness of that event—at least 250,000 people died—was not revealed for months, and offers of foreign help were spurned.

China's rulers are still proud and sometimes prickly, but for reasons good and bad they have changed. They got a nasty shock, for instance, in 2003 when an outbreak of severe acute respiratory syndrome, SARS, showed how a virulent new plague, if uncontained, might impose huge costs on a modernising economy. This taught them that burying bad news is not always sensible. A fierce freeze-up this January showed how the weather could also bring paralysis, less economically damaging perhaps but awkward all the same over a great national holiday. This showed them the merits of occasionally admitting imperfection, and even of offering a prime-ministerial apology. Since then they have learnt that beating up their Tibetan citizens may not be wise just as they are trying to impress the world with an Olympic extravaganza.

Such lessons have helped China respond more openly to the country's latest natural disaster. But no similar enlightenment is in store in Myanmar, certainly not soon enough to save the 2m people whose lives may be at risk if they do not receive more help. These people might be surprised to learn that in 2005 a World Summit of the UN endorsed the principle of an international responsibility to protect oppressed people from their persecutors (see article). True, any action taken would require Security Council approval and, true, the principle was adopted with armed oppression in mind. But “crimes against humanity” were specified and, if, say, a third of the 2m now struggling to survive in Myanmar were to die in the coming weeks from hunger and disease because their government refused outside help, that

surely would be such a crime.

It would certainly be a stain on the world's conscience, one indeed to rival the genocide in Rwanda, which claimed 700,000 lives. So what can be done? Legally, probably nothing. China and Russia would veto any resolution in the Security Council. Politically, too, any action that defied the generals would be controversial. Myanmar's neighbours are too morally insensible even to rebuke it in the councils of the Association of South-East Asian Nations. So the main task would probably fall to America, France and Britain, the only powers with ships nearby and able to act quickly in defiance of the generals.

As for the practicality of any action, that too is fraught. Unless, heaven forfend, an attempt were made to take over the administration of Myanmar, which would involve an armed invasion, the action would be confined to air drops. One difficulty is that the aircraft doing the dropping might be fired on unless they had military escorts, and that might lead to more fighting than anyone should want to see in a disaster zone. Another difficulty is that the effort to get food and medicines to people without the generals' consent might provoke them to halt even the pathetic flow of aid they are letting in.

Let them eat words?

Still, unless the generals relent, the attempt is worth making, because air drops might still save some lives, even though many are doomed. The first step should be a resolution in the Security Council. A veto would rob the action of strict legality, but paradoxically, by exposing the cynicism of the junta's apologists, help to gain it legitimacy. Then the drops should start.

More storms are forecast for Myanmar. If thousands more people are to die in the coming weeks, let those who oppose any action now, however modest its effect, then explain why they favoured a policy of doing nothing. And let them try to describe the circumstances in which the new-found responsibility to protect might actually be invoked if it is not just to join the UN's scrapheap of dashed expectations, broken promises and dismal betrayals.

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Zimbabwe's election

A huge risk that has to be taken

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Africa's leaders should give Morgan Tsvangirai a chance to meet the people's wishes

AFP

HORRIBLE scenes of government-sponsored violence are unfolding across Zimbabwe, as President Robert Mugabe and his band of thugs and crooks set about terrorising the people into reversing their decision, plainly expressed at the ballot box at the end of March, to chuck the old tyrant out of power. So the electoral odds are once again being tilted against Morgan Tsvangirai, Mr Mugabe's challenger. Nevertheless, the opposition leader is right to risk competing in a run-off that should not have been necessary.

It would have been understandable if Mr Tsvangirai, who officially won the first round of the presidential election on March 29th, and who very probably won it outright with more than 50% of votes cast, had boycotted a run-off. Mr Mugabe is bent on brutally swinging the vote his way next time round. Even by the massaged figures of the electoral commission, Mr Tsvangirai beat Mr Mugabe by nearly five percentage points in the first bout, when he was adjudged to have got 48% of the votes. The 9% collected by the third- and fourth-placed contestants in the first round would almost all go to Mr Tsvangirai in a fair run-off. However, if he had opted out of the contest in protest against previous vote fiddling, he would have let Mr Mugabe win by default. So, for all the likely shortcomings of the next poll, including a possible disgraceful further delay for several months, he felt bound to risk running once more. He still has a chance, albeit perhaps diminishing, of winning.

Even Mbeki could yet do the decent thing

Much will depend on the rest of Africa, most of whose leaders, in particular South Africa's Thabo Mbeki, have so far performed dismally out of a misconceived solidarity with one of their continent's nastiest dictators. The main African body meant to ensure a fair poll is the Southern African Development Community (SADC), a club of 14 countries (including Zimbabwe), some of whose members rarely have proper polls of their own. During Zimbabwe's March election it ludicrously prejudged the outcome as fair and shrank from telling Mr Mugabe's team to abide by a set of principles that SADC had itself laid down some years ago. For instance, according to SADC's principles, all sides should have fair access to the state media. In fact, Zimbabwe's only daily newspapers are government mouthpieces, and state television and radio ceaselessly vilify Mr Tsvangirai, a former trade unionist, as a puppet of the West. This does not seem to upset Mr Mbeki at all.

With Mr Tsvangirai's decision to run one more time, SADC and Africa's leaders have a chance to redeem themselves. For a start, SADC should bump up its monitors' numbers and try a lot harder than before to

scour the countryside, where would-be opposition voters and polling-station agents run an ever-increasing risk of being beaten up or even killed.

Mr Mbeki still seems loth to let SADC play a more robust pro-democracy role in Zimbabwe. But several slightly braver SADC leaders, including the club's current chairman, Zambia's Levy Mwanawasa, and Tanzania's Jakaya Kikwete, who chairs the bigger African Union, have had enough of Mr Mugabe; they should speak out even more loudly. It would be harder for Mr Mugabe to continue his intimidation if the UN and the European Union were also able to send election teams, but he has said no. His African counterparts have failed to persuade him otherwise.

Instead, their preferred tactic has been to eschew the idea of a fair poll in favour of trying to arrange a government of national unity, led for a transitional period by Mr Mugabe or someone other than Mr Tsvangirai. This would provide for Mr Mugabe's gracious exit, perhaps letting him choose a successor, probably as villainous as himself. That is too shoddy a compromise. Only if a unity government were led by the voters' true choice, Mr Tsvangirai, might it offer a way out of the impasse. Mr Tsvangirai says he would let Mr Mugabe retire in peace—a remarkably generous offer in the circumstances. The least Africa's leaders can do, if they are to be taken seriously, is to help Zimbabweans elect their own leader. Then the rebuilding, with generous help from the West, can begin.

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Travel and tourism

Asia, beware Benidorm

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Booming tourism in emerging economies promises huge benefits. But not if it copies the mistakes of mature markets

PA

WHEN low-cost air travel was taking off in Europe in the early 1990s, the German and the British ambassadors to Greece used to call each other at the end of each week during the summer, to compare notes on the bad behaviour of the visitors from their countries. No clear winner emerged. Sunburnt Brits and Germans would both get blind drunk, lose their money and passports, wind up in a fight at a beach bar and end the night in one of the Greek islands' police cells.

Tourism in Europe's Mediterranean countries is a big business, but it is not loved. It is blamed for polluting the landscape, spoiling the beaches and corrupting the locals' morals. This is partly the countries' own doing. In the 1960s the governments of Spain, Portugal, Italy and Greece encouraged the building of hotels and other tourist infrastructure, which seemed the fastest way to catch up with the wealthier north. During the 40 years of breakneck development that followed, vast stretches of the Spanish coast were concreted over, transforming the Costa del Sol into the Costa del Concrete and attracting hordes of tourists in search of sun, sea and sand. Some Greek islands have come to resemble a Hellenic Hong Kong, with high-rise hotels and traffic jams.

Some people in tourism made good money, but in recent years even they have started to notice how the ugliness and the noise is keeping visitors away. The government in Madrid grew so concerned that it bought tracts of seaside land itself, to stop developers from getting their hands on it.

The package and the bill

As tourism is about to explode in the developing world, governments should heed such lessons. During the next two decades the growth of tourism in emerging economies will be two or three times that of the developed world (see article). That is something to celebrate. Mass travel is a path to development and one of the fruits of increasing wealth—travel for experience, for food and culture, and for sheer pleasure. Yet it also contains the danger that development will destroy the very thing people have come to enjoy.

Emerging economies are suspicious about the developed world telling them to act responsibly. Why shouldn't they exploit their natural resources? A pristine hard-to-reach beach with a small exclusive hotel may be just what rich Westerners want; local fishermen would prefer new schools for their children. But with tourism, it is not so clear that rapid development really is in the locals' economic interest. If their government trashes their natural habitat, it is like an investment manager who pays you big dividends

out of your capital. The money is good for a while, but you lose in the long term.

Take care of your capital

That is worth remembering because the lesson from tourism in the West is that nobody keeps an eye on the capital. The bay, the ancient site, the coral reef and the fresh water have no single owner to protect them. The hotelier who raises a 1,000-room monstrosity will pay for the bricks and mortar, but not for scarring the view or wrecking an historic monument.

The question planners in these new markets should ask themselves is where they want tourism in their country to be in 20 years. At the moment tourists from emerging markets have their own tastes. Russians like two weeks on a sunny beach, wild parties and lots of retail therapy. The Chinese prefer urban travel to sea and sand. People from the Gulf states travel in big families and require *halal* food. Yet, with the progress of economic prosperity they will probably become more like Europeans and Americans, who want scenery, a decent environment and a smattering of history and culture. If you destroy your heritage and scenery, you will come to regret it.

From Mexico comes a cautionary tale. The country's Caribbean coast was once a natural paradise. Then data were fed into a government computer program. It digested the statistics and spat out the name of a potential touristic gold mine: a spit of sand called Cancún. Today Cancún has nearly 24,000 hotel rooms, roughly 4m visitors a year and an average of 190 flights daily. Mass tourism needs mass development, but don't pave paradise to put up a parking lot.

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On food prices, China, Vietnam, the Hoosier state

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Seeds of discord

SIR – The economic distortion in food prices caused by subsidies for biofuel ("The silent tsunami", April 19th) is dwarfed by the distortion caused by subsidies for livestock. In the West we continue to redistribute taxpayers' money to farmers, but in the process have neglected to price in the massive negative environmental externalities of the livestock industry. As well as overgrazing, soil erosion, desertification and deforestation, manure products with gaseous emissions have also had an effect on the environment; a single cow produces hundreds of litres of methane a day.

Feeding the world's poor is not an issue of insufficient global resources, but of inefficient resource allocation. We have diverted crops towards livestock, and now to cars, and away from hundreds of millions of hungry mouths.

Milan Shah
London

SIR – To blame policies that support biofuels for the overall high level of food prices is seriously misguided: how much rice, lettuce, or turnip is used for biofuel? Liberalisation in agriculture will increase the average price for food, but also its volatility. If you can't "stomach" that, then you need to regulate.

Patrick Chatenay
Canterbury, Kent

SIR – Do my fellow well-off liberals appreciate that by insisting on inefficient and expensive "organic" products with lower crop yields we are driving up the price of food?

Eric Evans
Montclair, New Jersey

SIR – You described Mexico's PROCAMPO programme for farmers as one based on conditional cash transfers (CCT) ("Reviving the ration card", April 19th). PROCAMPO is not a CCT programme. Mexico does have such a scheme, called *Oportunidades*, which transfers cash to poor families on the condition they take their children to health check-ups and keep them in school. PROCAMPO's main effect is to subsidise people with land. The vast majority of its beneficiaries are sellers of agricultural goods, most of whom are not poor.

Moreover, it is not the right programme for the current crisis in food prices, where an emphasis should be placed on helping the buyers of food. For example, the Mexican government could use *Oportunidades* to transfer more money to its beneficiaries so they can cope with rising food prices.

Nora Lustig
Visiting professor of international affairs
George Washington University
Washington, DC

SIR – Over the past 20 years very little effort has been put into increasing seed yields. Most funding in seed science goes towards genetically modified varieties that are resistant to herbicides. Farmers are sold seeds that "self-destruct" after one use, ensuring a customer for both seed and chemical year after year.

Furthermore, the distribution of food worldwide has relied on low energy costs to run the ships, lorries and aircraft that transport agricultural produce. The cheap fossil fuels on which that system relies are a thing of the past. What's needed now are farming methods that use less overall energy and produce food closer to home. As you pointed out, there is little arable land available and creating new croplands by continuing to destroy rainforests and fragile ecosystems is a cure worse than the disease.

Warren King
President
WellSpring Management
Oak Park, Illinois

China rising

SIR – I read your leader on a “snarling China” with interest (“Angry China”, May 3rd). Theodore White, in his 1978 book “In Search of History”, wrote that “to ignore the perception of China by the Chinese is to walk blind into their world.” He also said that “there still lies underneath Chinese manners an extravagant pride in descent and race which nothing can wipe out.” Isn't it possible that the Chinese are enormously proud of their national achievements, and that their reaction to criticism from the West could have been foreseen?

John Davidson
Vermillion, South Dakota

Why Vietnam prospers

SIR – To suggest that Vietnam's recent success is due to its compliance with “the catechism of the ‘Washington Consensus'” is wrongheaded (Special report on Vietnam, April 26th). Vietnam's early achievement in attaining Millennium Development Goals is the result of a cautious, step-by-step liberalisation, and shows how an effective state can use trade and integration to further its development without slavishly following the Washington rulebook.

The concern now is that Vietnam's increased integration in the world economy may have shrunk the breathing space that it has used so successfully to foster growth and equitable development. As a result, Vietnam may have a harder time riding out the global economic storm.

Steve Price-Thomas
Country director - Vietnam
Oxfam
Hanoi

SIR – If one of America's goals during the Vietnam war was to spread capitalism, then in the final analysis it has prevailed. Instead of feeling a sense of defeat and shame about Vietnam as it did when it evacuated its last personnel from its embassy's roof, America can now feel triumphant.

Khiem Tran
Kyle, South Dakota

SIR – You claimed that a revolt against authoritarian one-party rule in Vietnam is bound to appear eventually once the Vietnamese get used to broad economic and social freedoms (“Asia's other miracle”, April 26th). Modernisation theory makes a similar claim, that economic growth in an authoritarian state leads to democratisation.

But that theory now recognises that growth can help sustain all types of regimes, democratic and authoritarian. People are willing to accept less political rights if a government can provide them with a sustained comfortable life. Vietnam's impressive economic accomplishments do not necessarily mean it will embrace democracy, though that should not stop its people from pursuing their inalienable rights.

Stig Arild Pettersen
Amman, Jordan

What's in a nickname?

SIR – I noticed your article on Indiana's primary referred to the state's residents as “Hoosiers” (“More workaday than thou”, May 3rd). I thought your readers might be interested in some theories about how the Hoosier name came about. Some think Hoosier is a remnant of pioneering days, when curious folks would holler “who's here?” There are also references to “Hoosier's men”, labourers from Indiana employed by Samuel Hoosier to work on the Louisville and Portland Canal in Kentucky.

Others maintain the term stems from Indiana's fighting past. Brawling outsiders were quietened by “hushers”. And some say Hoosier derives from many bar-room brawls that ended with the exclamation: “whose ear?” As in the Democratic primaries, there is considerable disagreement on this issue, but we will always and everywhere rally behind this Hoosier identity.

Johannah Bendall
Fort Wayne, Indiana

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Lebanon

Iran's tool fights America's stooge

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EPA

A delicate balance between Christians, Druze, Sunnis and Shias has broken down. Reassembly will be hard

IT LOOKED disturbingly like a sequel to Lebanon's bloody civil war of 1975-90: gun battles in city streets, kidnappings, execution-style slayings and tearful vows of vengeance. With at least 81 people killed so far, the violence of past days represents the most serious internal strife since those years. And it is unclear who can stop it.

The most striking scene was the invasion of the capital, Beirut, mounted by opponents of the government. This was not exactly a conquest of the city, but rather the takeover of one part, Sunni-dominated West Beirut, by another, the dense, gritty and largely Shia-populated southern suburbs. This act quickly rippled across the mountainous country's sectarian patchwork, setting off clashes to the north and south. Because of Lebanon's position as a cockpit for regional power struggles, it also reverberated further afield, from Washington to the Iranian capital, Tehran.

It was natural that this latest turmoil should carry echoes of the civil war. That contest was only fudgingly resolved, and the country has struggled to recover. Small triumphs have been notched up here and there. One was the physical revival of Beirut from a bomb-scarred wreck to a gleaming magnet for tourism; another the brave popular uprising of 2005, which forced neighbouring Syria to pull out its long-overstayed “peacekeeping” troops. For many Lebanese, too, the hounding of Israel by the guerrillas of Hizbullah, the Shia party-cum-militia, leading to the Israeli army's withdrawal in 2000 after 22 years occupying the southern borderlands, and its humiliation in the 33-day war of 2006, were epic victories.

Syria's role

Yet none of those achievements was solidly shared by all. Reconstruction generated corruption and a giant pile of debt. Syria's removal alienated its many allies inside Lebanon and prompted it to sponsor what looks like a campaign of sabotage, including assassinations. The Sunni-led, anti-Syrian factions that gained power through the 2005 uprising failed to accommodate dangerous rivals, and suffered by close association with America.

Meanwhile, Hizbullah's lock-step allegiance to Shia Iran frightened not just Lebanese nationalists, but also the predominantly Sunni Arab world and Western powers. The UN Security Council resolved in 2004

that all Lebanon's militias must be disarmed, but Hizbullah insisted its noble cause was resistance to Israel, despite the Jewish state's abandonment of all but a tiny corner of Lebanon. The party continued to receive a supply of heavy weapons from Syria and Iran. In the end, the fight with Israel that Hizbullah provoked in 2006 brought massive and needless ruin.

Such strains would have tested any country, let alone a small one with a violent history, a population made up of 18 jealous religious minorities and a weak central state built on power-sharing between them. The wonder may be that Lebanon has held together at all, and even maintained a veneer of democracy. But this veneer has grown steadily thinner since the end of the 2006 war, which, aside from leaving 1,200 Lebanese dead and 100,000 homeless, also widened the central fissure in Lebanese politics.

This division is often defined, for simplicity's sake, as a split between Hizbullah, backed by Syria and Iran in the interest of confronting Israel and blocking American influence, against the Western-backed, democratically elected government of Fuad Siniora, the Sunni prime minister. The reality is more complicated.

Mr Siniora's coalition of Sunni Muslims, right-wing Christian parties, liberals, and the main Druze faction led by Walid Jumblatt, did indeed win 72 of the Lebanese parliament's 128 seats in the spring of 2005, riding on sympathy generated by the assassination of Mr Siniora's patron Rafik Hariri, a billionaire and five-term prime minister. But the election was run under rules drafted during Syrian control, before Mr Hariri's fatal falling-out with the Syrian regime. Many Lebanese Christians, who had been the core of opposition to Syria, felt these rules diluted their influence.

Moreover, the winning coalition, which adopted the name of “March 14th” after the date of a large anti-Syrian rally, secured some districts through an electoral alliance with Hizbullah. The Shia party was rewarded with seats in Mr Siniora's cabinet, but also believed there was tacit agreement to provide political cover for its massive rocket arsenal—perhaps, at some distant point, by incorporating its guerrilla force into the Lebanese army.

This alliance quickly unravelled, as Mr Siniora's Western backers pushed him to contain what they regarded as a terrorist group, and Hizbullah responded by forging a growing opposition coalition. This came to include not only its rival Shia party Amal, but also some pro-Syrian Christian, Sunni and Druze factions that had flourished, many with vigorous armed wings, under Syrian tutelage. Surprisingly, it was also joined by the Free Patriotic Movement (FPM), the Christian party of Michel Aoun, a maverick former general who had led a rising against Syria at the close of the civil war.

Mr Aoun bore several grudges against March 14th. As a battle-hardened foe of Syria, he felt entitled to a leading role after Syria's hasty withdrawal. He wanted to replace Emile Lahoud, the garishly pro-Syrian president whose term was due to expire in November 2007. (By custom, Lebanon's president must be a Maronite Christian, its prime minister a Sunni Muslim, and the speaker of parliament a Shia.) The FPM far outpolled the Christian parties inside Mr Siniora's coalition, reflecting wide distrust of the older, right-wing Christian parties who had gained a reputation for thuggery during the civil war.

The jigsaw puzzle

Lebanese factions

March 14th alliance*	Religious groups	Leader
Future Movement	Mostly Sunni	Saad Hariri
Progressive Socialist Party	Druze	Walid Jumblatt
Lebanese Forces	Maronite Christian	Samir Geagea
Kataeb Party	Maronite Christian	Amin Gemayel
ALSO: smaller anti-Syrian parties, liberals, independents, dissident Shias		

Opposition alliance	Religious groups	Leader
Hizbullah	Shia	Hassan Nasrallah
Amal	Shia	Nabih Berri
Free Patriotic Movement	Mostly Christian	Michel Aoun
Syrian Social Nationalist Party	Mostly Orthodox Christian	Ali Qansuh
ALSO: pro-Syrian parties, dissident Sunnis, most Armenians, most Alawites		

Source: *The Economist* *Government loyalists

In Hizbullah's embrace

Mr Aoun's abrasiveness, and March 14th's unwillingness to give him the presidency, ensured that the FPM remained in opposition. It was widely assumed that with his anti-Syrian credentials and largely pro-Western Christian constituency, the general would avoid Hizbullah, yet the two parties made an alliance in February 2006. Mr Aoun lost some Christian support over this, but then came the war with Israel.

Most Christians blamed Hizbullah for the fighting. Yet many also credited the FPM, which mobilised aid for thousands of Shias displaced by the war, with healing a historic rift between the traditionally dominant but dwindling Christians and the long-disenfranchised but now formidable Shias. In Hizbullah's view, the alliance with Mr Aoun allowed it to clothe its Iranian-tinted Islamist militancy in Lebanese nationalist colours.

Hizbullah emerged from the war with its prestige enhanced, and speedily boosted it further with a big and efficient Iranian-financed reconstruction programme. By contrast, Mr Siniora's government, reduced during the war to issuing vain pleas to its Western friends to fend off the Israeli onslaught, looked vulnerable. It was given little credit for helping secure the eventual ceasefire, and even less for winning massive pledges of aid from Sunni Gulf countries. Privately, supporters of March 14th believed Hizbullah had recklessly exposed Lebanon to disaster. Yet the trauma of the war, and the sight of Israel, for the first time, being mauled by an Arab force, kept them quiet.

Soon after the war's end, in November 2006, the opposition moved to cash in their political gains by demanding a national unity government, in which their members would have enough cabinet seats to block its decisions. Mr Siniora refused, suspecting a Syrian-inspired plot. The opposition responded by withdrawing the cabinet's six Shia members. This, they said, rendered the government illegal, since it was constitutionally required to represent all the main sects. The Shia speaker of parliament, Nabih Berri, leader of Hizbullah's sister party Amal, refused to convene the legislature. Over subsequent months the opposition increased its demands, including a revision of electoral laws to address Mr Aoun's concerns that Christians were being cheated.

As the lame-duck presidency of Mr Lahoud came to an end in November last year, the opposition stalled talks over the successor to be elected by parliament. Agreeing at last on Michel Suleiman, who commands the non-sectarian army, it insisted that its other conditions be fulfilled before Mr Berri summoned parliament.

So, to the frustration of ordinary Lebanese, the factions have produced an 18-month stalemate. Hizbullah and its allies call the government an American stooge; March 14th blasts the opposition as a tool of Iran and a cat's-paw for Syria. Mediators, including Amr Moussa, chief of the Arab League, have come and despaired.

The galvanising moment

March 14th has naturally tried to drive a wedge between Hizbullah and its Christian allies. Earlier this month, citing alleged evidence of suspicious traffic monitoring at Beirut airport, it reassigned the pro-Hizbullah head of airport security. It also declared illegal the party's communications network. If this was

intended to highlight to Christians and Western powers Hizbullah's rogue status, it backfired. On May 8th Hizbullah's carefully-spoken leader, Hassan Nasrallah, described the government's moves as “treachery”, and said the time had come to defend the arms of the “resistance”.

Within minutes, a combined force of Hizbullah, Amal and allied fighters blasted their way into Beirut's Sunni quarter, eventually surrounding the residences of Mr Hariri's son and political heir, Saad, and of his Druze ally Mr Jumblatt. By May 10th fighting moved to outlying areas, affecting Mr Jumblatt's stronghold in the Chouf mountains south-east of Beirut and the Sunni-dominated north, as Mr Hariri's allies exacted revenge on pockets of opposition fighters. In other tit-for-tat action, Hizbullah blocked access to Beirut airport, while Sunni militiamen sealed the road to Syria's capital, Damascus.

The opposition stopped short of overthrowing the government, though it probably could have done so. It also promptly handed over control of most areas it invaded to the Lebanese army, ushering in a nervous calm after five days of fighting. But the 70,000-man army, which is wary of being infected itself by sectarianism, is scarcely a match for Hizbollah's trained and hardened guerrillas.

Government leaders have declared they will not be cowed by force of arms. Yet they have already backed down on the immediate issues that angered Hizbullah. Other concessions are likely to follow, if the Arab League, which has sent in a hurried diplomatic mission, can find a face-saving formula. This might include swift passage of electoral reform, the installation of Mr Suleiman as president and the formation of a “technocratic” transitional government before fresh elections.

This may all prove a tall order, however. The sense of injury among non-Shias is powerful, as is the urge for March 14th to exploit for political advantage Hizbullah's breaking of a long-standing pledge never to use its arms in internal squabbles. Should the government refuse to bend, the chances are that its opponents will push back even harder. Such a result, tipping Lebanon back into full-scale conflict, would suit no one.

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John McCain

It won't be a walk in the woods

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AP

The race is on in earnest, but his party's chances look grim

THE most interesting election result on May 13th was not Hillary Clinton's 41-point victory over Barack Obama in the Appalachians. It was the Republicans' loss of an ultra-safe seat in a special election in northern Mississippi. West Virginia was the swan-song of a dying campaign. Mississippi was a harbinger of disaster for congressional Republicans in November—and a warning of how difficult it will be for John McCain to win the White House.

It is rare for a party to win a third presidential term. The only time it has happened since Harry Truman's time was in 1988. Back then the retiring president, Ronald Reagan, had a job-approval rating in the high 50s. George Bush's job-approval rating is stuck in the low 30s. Nearly three in four Americans tell pollsters that the country is on the “wrong track”.

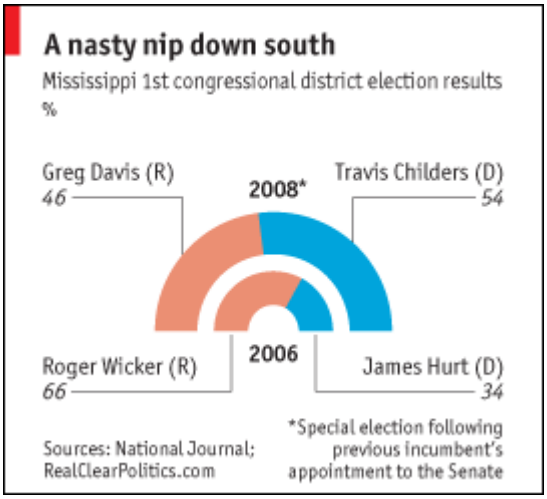
The Mississippi result demonstrates that the anti-Republican mood, which gave the Democrats control of both the House and the Senate in 2006, is getting ever stronger. In 2004 the Republicans won the seat with 79% of the vote; they took it in 2006 by 66% to 34%. This is the third safe seat in a row that the Republicans have lost.

On March 8th they lost Dennis Hastert's seat in Illinois, a district that George Bush carried by ten points in 2004. They lost another safe seat, this one in Louisiana on May 3rd, that they had held for 33 years. And then they lost the Mississippi seat as well. Chris Van Hollen, the chairman of the Democratic Congressional Campaign Committee, gave warning: “there is no district that is safe for Republican candidates.”

But does this mean that the party's unpopularity will drag down Mr McCain? It is true that the senator is no identikit Republican. He has spent years railing against the pork-barrel spending that has alienated so many rank-and-file Republicans. He has embraced un-Republican issues such as global warming, speaks to Hispanic groups such as La Raza, and conducted a tour of impoverished America. He stood in New Orleans's devastated ninth ward and condemned the Bush administration's lamentable handling of Hurricane Katrina. If any Republican can survive an anti-Republican hurricane, it is Mr McCain.

Equally, though, Mr McCain cannot survive without the support of Republican stalwarts. These are the people who man the phone banks and knock on doors. They are also the people who fill the coffers. Accordingly, Mr McCain has abandoned his

earlier opposition to Mr Bush's tax cuts and re-emphasised his support for appointing conservative judges.



But many activists still regard him as a cuckoo in the nest. Mr McCain has not broken 80% of the vote in Republican primaries since securing the nomination. He won only 73% in the vital state of Pennsylvania. If Bob Barr, a former Republican turned libertarian, wins the Libertarian Party's nomination, he could attract disillusioned Republican votes in November.

Mr McCain faces an expanding and energised Democratic Party that is desperate to retake the White House. In many primary states twice as many Democrats have turned out to vote as Republicans. And he is on the wrong side of the two biggest issues at the heart of the election. The first is the war in Iraq. Mr McCain—or “McStay” as the Democrats have taken to calling him—is an instinctive hawk at a time when America has grown weary of foreign entanglements (60% of Americans think that the Iraq war was a mistake, for example). MoveOn.org, a Democratic pressure group, is running endless ads quoting Mr McCain saying that America could be in Iraq for another hundred years, a statement that could come to define him—much as John Kerry's statement that he voted in favour of funding the war before he voted against it defined him as a flip-flopper in 2004.

The second issue is change. For all his maverick reputation, Mr McCain goes into the general election wearing a scarlet “R” and tainted by his association with Mr Bush. The fact that he is 71 also makes it difficult for him to cast himself as an agent of change. Mr Obama repeatedly says that “We can't afford to give John McCain the chance to serve out George Bush's third term.” For all his talk of being above partisan bickering, Mr Obama has also been happy to play the age card, accusing Mr McCain of “losing his bearings”.

Mr McCain is also up against a formidable political machine. The McCain camp has repeatedly hinted that they regard Mr Obama as a weaker opponent than Mrs Clinton. Some conservatives persist in seeing him as a cross between Michael Dukakis and George McGovern. But they underestimate the Chicagoan at their peril.

Mr Obama has put together the most disciplined and creative Democratic political machine in recent memory—one quite capable of defeating the formidable Clinton machine. Mr Obama already has a national political apparatus in place, thanks to the prolonged Democratic primary. He also has money coming out of his ears. Mr Obama raised $41m in March compared with Mr McCain's $15m. Mr McCain's likely decision to take public funding will limit him to $84m in the two months before the election. Mr Obama will be able to raise many times that amount.

Mr Obama certainly has weaknesses that the grizzled Republican can exploit. Mr McCain, a war hero, is up against a man who had doubts about wearing a flag pin. The Arizona senator is a genuine “reformer with results”—a man with a long record of taking on vested interests and working with the opposite party—who is up against a man with the most liberal voting record in the Senate. With the Democratic nomination all but settled, the real fight is now on. But Mr McCain is swimming against a mighty tide.

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On the campaign trail

Primary colour

May 15th 2008
From The Economist print edition

His master's voice

"I also want to say, on instructions, I've been a Democrat all my life...I'm here to tell you that however these last states come out, my candidates, our family and our supporters will be here to get a victory in November for the Democrats."
Bill Clinton campaigning in Montana. ABCNews.com, May 11th

Playing dirty

"Swift Boat times five on both sides."
A McCain adviser on how nasty the general election is likely to be. Newsweek, *May 19th*

Voice of an angel

"When Bush tries to articulate a vision, he will butcher the Gettysburg Address. Obama, he will make an A&P grocery list sing."
Outgoing Republican congressman Tom Davis thinks his party should be wary of attacking Barack Obama. Washington Post, *May 11th*

For sale

"Nobody showed me any money yet."
Steven Ybarra, an undeclared superdelegate from California, says he is prepared to endorse any candidate who gives him $20m to register Hispanic voters. Associated Press, May 7th

Illustration by Claudio Munoz

American Idol

"The worst thing in the world is when an entertainer doesn't know when the show is over. The audience is gone, the lights are down, you're getting ready to cut the mikes off and you are still on the stage singing."
Al Sharpton advises Hillary Clinton that the time has come to retire gracefully. CNN.com, May 9th

Little faith

"50% off!"
Souvenir shops in Washington, DC, area airports are already reducing Clinton '08 items. ABCNews.com, May 12th

Miss Manners

"She is tireless, she is smart, she is capable, so obviously she'd be on anybody's short list...but it would be presumptuous of me at this point, when she is still actively running for me to somehow suggest that she should be my running mate."
Mr Obama on Mrs Clinton. CNN, May 8th

A mother's love

"He's not perfect. Did I say that?"
Roberta McCain appears in an advertisement for her son on Mother's Day. CNN, May 9th

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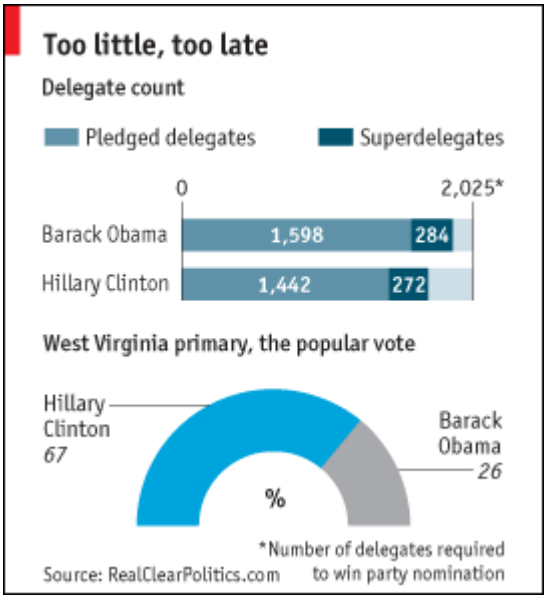
West Virginia

The phoney war continues

May 15th 2008 | CHARLESTON
From The Economist print edition

Too late, Hillary wins a big victory

IN LOGAN, the local high school's cheerleaders wrote a chant for Hillary Clinton's visit on May 12th: “H-I-L-L-A-R-Y, Hillary, our nominee!” In Fairmont, her supporters printed T-shirts reading, “We Need A Mama, Not Obama”. And on May 13th Mrs Clinton won West Virginia's Democratic primary by a whopping 41 points, almost the largest margin of her candidacy so far. For Mrs Clinton, the state is “almost heaven”, she said, quoting John Denver's “Country Roads” to a raucous crowd of supporters.



The state's profile is, indeed, perfect for Mrs Clinton: West Virginia's Democrats are relatively poor, undereducated, ageing and overwhelmingly white. With one of the highest number of veterans per head in the country, the state takes displays of patriotism—such as flag pins—very seriously. Barack Obama visited the state only once, and when he did he admitted he was likely to lose.

Although Mrs Clinton's head is in Appalachia's heavenly peaks, only a miracle can save her candidacy now. On May 14th John Edwards, who ran a respectable third in the Democratic stakes thanks to his appeal to white working-class voters, endorsed Mr Obama. Mr Obama has just taken the lead even in superdelegate endorsements, the last meaningful measure to favour Mrs Clinton. And despite her thumping victory in West Virginia and her likely win in Kentucky on May 20th, Mr Obama will finish the primary season with more delegates and more votes than Mrs Clinton. In Washington, regardless of both successes, the debate is still all about not whether she will concede but when, and how.

Not so in West Virginia. The state is mostly Democratic, but plumped for George Bush twice; its voters want a populist they can back in the general election. “It's not over,” the crowd kept yelling at her victory party in Charleston. Many still hope Mrs Clinton will win the majority of raw votes, convincing most uncommitted superdelegates to put her over the top.

West Virginians also don't like Mr Obama. “He doesn't connect too good,” one of the state's many Clinton supporters explains. Democratic voters there fret that he disdains their faith and their guns. Half say they will vote for John McCain or stay home if Mr Obama gets the nomination.

For months Mrs Clinton's advisers have insisted that they can do the maths just as well as the press can. One of them recently estimated that she has about a 2% chance of taking the nomination. Dick Morris, a former adviser to Bill Clinton, speculates that she is trying to render Mr Obama unelectable, thereby setting herself up for a run against a 76-year-old John McCain in 2012. Others wonder if she is aiming a bit lower, for the vice-presidential nomination, despite all the bad blood between her and Mr Obama.

Besides, on the trail Mrs Clinton looks as determined as ever to win the nomination. She points out that no Democrat has taken the White House without West Virginia's support since 1916, a line as much for uncommitted superdelegates as for her crowds. She aims to save the party from itself. In her victory speech, she repeatedly insisted that she is the stronger candidate—warning the undecided not to bet on Mr Obama. On primary night, both she and Terry McAuliffe, her campaign chairman, promised not to leave the race before every state has voted. Just enough time, perhaps, for Mr Obama to get himself embroiled in a career-ending scandal.

She may be determined, but her superdelegates will want to start making up to Mr Obama soon. Barring a miracle, Mrs Clinton's more self-important supporters will not stick with her much longer.

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Urban crime

The mystery of violence

May 15th 2008 | CHICAGO
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Chicago's continuing fight against gangs and guns

APRIL was a cruel and bloody month in Chicago. “We want futures, not funerals!” students shouted at a rally on April 1st. But more funerals followed. The most violent weekend, April 18th-20th, saw no few than 36 shootings—15 of them gang-related—and nine deaths. As Chicago prepares for the summer, when violence usually tends to rise, two questions linger: what has caused this outburst, and what can be done about it?

Some believe the shootings were sparked by warmer weather; others blame mounting economic hardship. But searching for a precise reason is pointless. In many neighbourhoods across America, the threat of violence hangs in the air like humidity, sometimes bursting into a deluge. Overall crime rates are far lower than in the early 1990s. But America had 37% more gang-related murders in 2006 than in 2000, according to FBI reports. Half of Chicago's murders in 2006 were linked to gangs.

The more important question is whether cities have learned how to prevent further outbursts. Chicago's police now use an array of tactics, from targeting “hot spots” to a community-policing programme. Richard Daley, Chicago's mayor, has long sought to reform gun laws and work more closely with federal officials to dismantle gangs' financial operations.

April's violence has inspired new plans, some more helpful than others. The ineffectual governor of Illinois, Rod Blagojevich, announced on May 6th a $150m scheme for which there is no $150m. Chicago's police chief intends to make residents feel safer by sending out SWAT teams in full battle gear. More promisingly, Mr Daley wants to keep pools and parks open late and offer more teenagers summer jobs. This will help keep more children busy and out of harm. But it will have little effect on the most violent.

Chicago's muddled response frustrates David Kennedy of the John Jay College of Criminal Justice in New York. He notes that in the 1990s Boston brought together federal, state and local agencies, community groups, religious leaders and others (including himself) to fight violence. A main feature of the scheme was to locate gang members and tell them that help and services were available, but that violence would be met with severe penalties. If someone was killed, not only would prosecutors pursue the killer, but police would nail other gang members for smaller crimes. This would create an economic disincentive to kill—shooting a rival would badly disrupt gang business. The programme was launched in 1996. Youth murders plummeted. Long-term studies show a two-thirds drop.

Chicago has its own version of this strategy in six police districts, but it has been all but ignored in the current cacophony. A federal initiative called Project Safe Neighbourhoods (PSN) pays for the programme; the federal district attorney directs it. Chicago's PSN includes tough gun policing, federal prosecutions and—most important, or so researchers found—meetings with former felons to deter them from returning to crime. Over PSN's first two years, the districts it targeted saw a 37% drop in quarterly homicide rates. The challenge now is to help PSN expand. Chicago's leaders must use many tools to fight violence. One is right under their noses.

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Gambling

Bringing Vegas to the east

May 15th 2008 | LEDYARD, CONNECTICUT
From The Economist print edition

An Indian casino hopes to add some grand gambolling to its gambling

WITH its turquoise towers bursting from the Connecticut trees, Foxwoods casino is oddly reminiscent of the Wizard of Oz's Emerald City. It has recently added some Las Vegas surreality by going into partnership with MGM Mirage, owner of some of Vegas's biggest casinos, including the Bellagio and Luxor. The opening, planned for May 17th, promises to bring more of that Nevada glitz. John Mayer and Alicia Keys are performing in a new auditorium modelled on Hollywood's Kodak theatre. Michael Douglas and Catherine Zeta-Jones are coming. Sean “Diddy” Combs is hosting an exclusive after-party at “Diddy's Den”.

Foxwoods, already North America's largest resort casino, is hoping that its $700m expansion will add glamour, raise hospitality standards and bring in more punters. The partnership is really a licensing agreement. Foxwoods will continue to own and manage the new facility; MGM receives a percentage of the earnings and acts as a consultant. David Schwartz of the Centre for Gaming Research says it will also bring in its player database, specifically its Vegas high-rollers.

The Mashantucket Pequot Tribal Nation opened its first bingo hall in 1986 and its Foxwoods casino in 1992. Today it has 40,000 visitors daily, most coming from next-door Massachusetts. Other Indian tribes have had similar agreements, as Alan Meister, an economist with Analysis Group, points out. Harrah's, the largest gambling company in the world, has linked up with tribes in Arizona and California. What makes MGM's foray different, he says, is that Foxwoods is already established. Gillian Murphy, general manager of MGM Grand at Foxwoods, is hoping to keep current visitor numbers but also to attract New Yorkers. According to one industry report, a mere 9% of its patrons in 2007 came from New York, which is only two-and-a half hours away.

Among Indian casinos, Foxwoods and the nearby Mohegan Sun take in the most revenue from gaming in the country: some $2.4 billion in 2007. Connecticut's state coffers receive 25% of their net takings from slot machines. The payment totalled $430.5m last year, which is more than half the amount collected through the state's corporate income tax. “There has never been so much gaming in the north-east,” says Barry Cregan, president of Foxwoods. He points to new Indian casinos and racinos (racetrack-cum-casinos) in New York, and commercial racinos in Rhode Island and Pennsylvania. But he thinks there is still room for growth. The Mohegan Sun, too, plans to expand by opening a new $925m hotel and casino by next year.

Standard and Poor's recently downgraded its rating for Mohegan Sun because of the softness in the Connecticut gaming market. Slot machine revenues are down at both Mohegan and Foxwoods. Gambling has also dipped a bit in Atlantic City. Along the Las Vegas Strip, it fell 4.8% in March, the third consecutive monthly decline. But the folk at Foxwoods and Mohegan are still full of hope.

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George Bush and Texas

Meanwhile, back at the ranch

May 15th 2008 | CRAWFORD
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A small town prepares for the end of the Bush years

MANY Americans were disappointed when Jenna Bush decided against a White House wedding. But Jo Staton understands why Miss Bush wanted to have her nuptials, which took place on May 10th, at the family ranch just outside Crawford, Texas. “She's down to earth,” said Ms Staton. “She's like her daddy.” That is in contrast to Miss Bush's twin sister, Barbara, who is slightly more “hoop-de-doo.”

Ms Staton has lived in the tiny town of Crawford all her life. George and Laura Bush have been part-time locals since 1999, when they bought their ranch. Cynics suspected that Mr Bush, then the governor of Texas and a presidential candidate, wanted a place to act the cowboy for the benefit of the press. That may have been true. But by now it has become clear that Mr Bush really does enjoy the place. In 2006 he told a German newspaper that the best moment of his presidency was when he caught a seven-and-a-half pound (3.5 kg) largemouth bass on the lake at the ranch.

Another high point came in 2004. In the space of a month Mr Bush won re-election and the town football team, the Crawford Pirates, won the state championship in its division. The president announced the good news at a press conference, “in case you're not following high school football in Texas.” Man and town went through hard times, too. His holidays there became a point of contention after the terrorist attacks of September 11th 2001. He had spent more than a month at the ranch that summer, even though, as he later put it, America's enemies are never tired. In August 2005 Cindy Sheehan set up camp in Crawford after her son was killed serving in Iraq. Hundreds of anti-war activists joined her demonstration.

Collisions with history have become old hat around Crawford. The souvenir shops stock mugs celebrating the town's most important visitors, such as Vladimir Putin and Angela Merkel. But lately business has slowed. Ms Staton, who helps out at the Red Bull tavern, attributes this to the rising price of petrol: once tourists make it to town, about 15 miles west of Waco, they do not have much money left over. Still, her guest book includes recent visitors from Poland, England and China. Oh, and someone supposedly called “Barak Obama” of “Loserville, California”.

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Lexington

Why not both?

May 15th 2008
From The Economist print edition

Illustration by Kevin Kallaugher

The dubious case for a Democratic dream team

BACK in March Barack Obama compared the Democratic primary to a “good movie” that has lasted “half an hour too long”. The movie has long since gone bad, and half an hour has dragged into an eternity. Surely it is high time to roll out the Hollywood ending.

And what could be more Hollywood than a dream ticket? This has the support of plenty of senior Democrats such as Mario Cuomo, the former governor of New York, and Ed Rendell, the governor of Pennsylvania. Why stop at having a nominee who has the support of 51% of Democrats, the argument goes, when we could have a dream ticket that has won 100%? A couple of months ago Hillary Clinton signalled that she would be willing to have Mr Obama as her vice-president. Perhaps it is time for her to swallow her pride and take the second spot.

The “dream ticket” would reunite a party that has fractured along lines of race and class. Mrs Clinton would boost her chances of getting the presidency some day (a third of all vice-presidents have gone on to the top job). And Mr Obama would acquire a street-fighter with a proven record of appealing to voters that he finds hard to connect with. There are plenty of examples, including the Kennedy-Johnson ticket in 1960 and the Reagan-Bush ticket in 1980, of bitter rivals turning themselves into successful allies.

The trouble with this argument is that it overstates the benefits of an Obama-Clinton partnership and understates the costs. Mrs Clinton certainly has genuine appeal to female voters, particularly the older and less educated women who were moved by her tears in New Hampshire and have since been enthused by her dogged determination. But most of these voters are hard-core Democrats who are unlikely to defect to John McCain in November. The Democrats' biggest problem is not with white women but with white men—particularly with white working-class men—who have been drifting to the Republican Party for decades. No less than 62% of white men voted for George Bush in 2004. John McCain, a war hero and man's man, has an obvious appeal to this group; that appeal might prove irresistible if the Democrats pair a black man with a white woman.

The Democratic Party has plenty of people who have more genuine appeal to the white working classes than a faux populist such as the Wellesley- and Yale-educated former first lady. Ted Strickland, the governor of Ohio, is a former Methodist minister who might help Mr Obama connect with religious voters. The same can be said of Tim Kaine, the governor of Virginia and a former missionary. Mr Rendell, the governor of Pennsylvania, goes down well with the beer-and-football crowd (he moonlights as a commentator for football matches). Unlike Mrs Clinton, these men represent vital swing states. Or there is John Edwards, who has run for veep before, and who has just endorsed Mr Obama.

There are also several others who might do much more than Mrs Clinton to make up for another of Mr Obama's potential weaknesses—his lack of foreign policy and defence experience. Wesley Clark, Jim Webb and Chuck Hagel are all former Vietnam war heroes. Mr Clark is a retired four-star general who once commanded NATO. Mr Hagel, a Republican senator for Nebraska and a former best buddy of Mr McCain, has been one of the most outspoken critics of the Iraq war. Mr Webb, a Democratic senator for Virginia, was secretary of the navy under Ronald Reagan. Why choose an armchair warrior who has been reduced to inventing stories about dodging sniper fire in Bosnia when you can choose a genuine warrior instead?

Then there is the downside of the dream ticket. Mr Obama's best selling-point is that he represents “change” and “hope”—a chance to break with the old politics of partisan division and personal destruction and to bring a new spirit of reconciliation to Washington, DC. The Clintons are not only living reminders of the noxious politics of the 1990s. Exit polls in Indiana and North Carolina showed that almost half of voters in the Democratic primary did not regard Mrs Clinton as trustworthy. They also bring a menagerie of old-timers in their wake, from high-paid lobbyists such as Mark Penn, to perennial bloviators like Paul Begala and James Carville.

How not to do it

The dream ticket would also be a formula for a dysfunctional administration. It is hard to imagine Mrs Clinton contenting herself with a purely symbolic role, any more than Dick Cheney has. She spent the early 1990s turning the position of first lady into a virtual co-presidency. She is married to a former president who has lost none of his self-regard. Team Clinton is full of people who have made it clear that they regard the Obamaites as uppity whippersnappers.

Does America really want the vice-president's office to become—or rather remain—a rival power centre to the Oval Office? That could mean going back to the 1990s, when the White House was consumed by palace intrigue between rival factions, each determined to advance their own agendas and do down their rivals. The presidency is difficult enough to run at the best of times, without installing a former first lady and an ex-president in the vice-president's residence.

Mr Obama will find it hard to resist pressure for a shotgun marriage to Mrs Clinton. His terrible result in West Virginia this week underlines once again his weakness with the white working-class. And Mr Obama cannot win the nomination without the support of superdelegates, who are desperate to reunite a divided party. But putting Mrs Clinton on the ticket would produce few benefits that could not be replicated with a carefully chosen alternative vice-president. And at worst it could lay the foundations of a failed presidency.

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Drug violence in Mexico

Can the army out-gun the drug lords?

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From The Economist print edition

AP

Four top police officers, and more than a hundred people, are killed over the course of a single week in drug-related shootings

“FEAR is our chief safeguard,” Pericles declared in his funeral oration, “for it teaches us to obey the magistrates and the laws.” In Mexico, however, fear has become the chief aid not of the state, but of those who are trying to subvert it. On May 8th, Edgar Millán Gómez, Mexico's acting chief of police, was shot nine times as he arrived home late at night. One of his bodyguards, who was also wounded, managed to wrestle the police chief's assailant to the ground and arrest him. Mr Millán was conscious for long enough to ask his killer who was behind the hit, but died before he could get a reply.

The answer to his question, provided later by investigators, helps cast some light on why it is so hard to end drug-related violence in Mexico. They say that his assassin was sent by José Antonio Montes Garfias, another federal police officer. Furthermore, the people who organised Mr Millán's killing were also behind the assassination on May 1st of Roberto Velasco Bravo, head of the federal police's organised crime division.

In addition to Mr Millán's assassination, the past few days have seen the murder of a top official in Mexico City's police force; of the police second-in-command in the border town of Juárez; and of the administrative head of the Estado Mayor, a military body charged with protecting the president. Such targeting of senior law-enforcement officials is unprecedented in Mexican history.

The gangs have not restricted themselves to killing senior policemen, though. According to Guillermo Zepeda of CIDAC, a think-tank in Mexico City, the week leading up to May 12th saw a total of 113 murders in Mexico, including 17 people on a single day. Estimates of the total number of deaths linked to drugs and organised crime so far this year range from 1,100 to 2,500 people. The war on drugs has never seemed less like a metaphor.

The involvement of the police in some of the killings helps to explain the lack of sympathy for dead policemen. “When police die in the line of duty, there is no condemnation of the violence in society,” says Ernesto López Portillo of Insyde, another think-tank. Part of the problem, he says, is that it is impossible to know which police officers lost their lives because they were doing their jobs, and which ones died because they were allied with a drug gang. The lack of public confidence in the police undermines their effectiveness and makes them more open to corruption.

Unable to rely on the police, President Felipe Calderón's habitual response to violence has been to send the army into trouble spots. This week the president dispatched 2,700 federal troops and police to the

state of Sinaloa, where much of the violence has taken place. The army is now widely deployed around the country. Some Mexican legislators are even calling for troops to be deployed in Mexico City. Replacing the police by the army while the former were being reformed was meant to be only a temporary measure. But it is fast taking on an air of permanence.

As no figures are available for the volume of drugs being traded, the best way to measure it is to look at what is happening to drug prices north of the border. Mexico used to be one of the world's biggest producers of methamphetamines, and Mexican gangs still control meth distribution in the United States. They also dominate the wholesale distribution of cocaine there, as well as the transit of the drug through Mexico from South America. According to the United States' Drug Enforcement Administration, the average price of methamphetamine jumped 73% between January and September last year (the most recent figures available). The price of cocaine rose by 44% over the same period, despite a decline in purity.

The recent killings are a response to this success. Police officials said the murders of Messrs Millán and Velasco were probably both ordered by Arturo Beltrán Leyva, a *capo* in the Sinaloa drug cartel. Mr Beltrán Leyva's brother, another Sinaloa leader, was arrested in January. Joaquin Guzmán, the gang's head, escaped from prison in early 2001 under still unexplained circumstances. Government pressure has also prompted infighting among the gangs; Mr Guzmán's son was killed the same day as Mr Millán in a shoot-out thought to have been between his father's faction and a rival group from Juárez.

But setting the army on the drug-traffickers cannot be a permanent solution to the problem. The army was not trained for this job and has come under heavy criticism from human-rights groups. The government has shown little tolerance of this, forcing (according to some accounts) the representative of the UN High Commissioner for Human Rights to leave the country for being too critical of the army.

In a speech after the latest killings, the president called for “a transformation in the administration of justice”. Under a controversial new law, due to come into effect soon, the police will be allowed to hold suspected drug-traffickers and other suspected participants in organised crime for up to 80 days without charge. But a real transformation means a greater upheaval of the police, something that Mr Calderón promised when he first deployed the army nearly a year and a half ago, though there is little sign of it yet.

America is partly to blame. Last October the American and Mexican governments announced a plan under which the United States would contribute $500m a year to Mexican law-enforcement, equipment and training. But neither government bothered to consult its legislature. The programme is now stalled in the United States Congress. As its research service dryly noted in March, “there is no legislative vehicle for the funding request”, and that is still true. If the programme does ever materialise, it will almost certainly be a lot smaller in scope.

Thickening the blue line

Furthermore, some say the plan is not particularly well thought through. Geoff Thale of the Washington Office on Latin America, a think-tank, told the United States Congress that the approach to police training, a centrepiece of the initiative, was wrong to focus on creating specialised police units, which could easily be undermined or corrupted, rather than concentrating on institutional reform.

The status quo leaves both the army and the police vulnerable. In a brazen bit of nose-thumbing, the Zetas, a paramilitary wing of the Gulf cartel (the Sinaloa gang's main rivals), recently hung up banners in several border towns inviting current and former soldiers to join them. The Zetas themselves were originally formed by army deserters.

Following this week's murders, Eduardo Medina Mora, Mexico's attorney-general, said that the violence was a sign of “weakness, desperation, and frustration” on the part of organised crime. That is partly true. But as Mr Millán's killing makes clear, the distinction between law-enforcement authorities and organised crime is sometimes blurred. So far Mr Calderón's administration has failed to come up with a solution to an abiding paradox: success in disrupting drug cartels only leads to more violence as gang members fight to fill power vacuums and continue to supply the ever-lucrative drug market.

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Colombia's paramilitaries

Free trade in thugs

May 15th 2008 | BOGOTÁ
From The Economist print edition

Getting tougher with right-wing warlords

AP

Relocating his business to the United States?

IN A surprise move on May 13th, President Álvaro Uribe announced the extradition to the United States of 14 of Colombia's most notorious paramilitary warlords on drug-trafficking charges. As well as sending a warning to other right-wing paramilitaries, the aim is to show Democrats in Washington that Mr Uribe means what he says about breaking with paramilitary groups who continue to murder trade unionists and other left-wingers.

Democratic congressional leaders and their trade-union allies have cited those murders as a reason for their refusal to approve a free-trade agreement with Colombia. Mr Uribe may also be hoping to boost his already soaring approval ratings to strengthen his hand in an eventual bid for an unprecedented third term as president. More than two terms in a row are currently banned by the constitution, so this would require approval by Congress.

Mr Uribe's move could backfire. Human-rights groups fear that it will rob the victims of the compensation that they are entitled to from their tormentors, and could also remove the evidence needed for a successful investigation into why Colombia's paramilitaries and their political accomplices have hitherto enjoyed impunity. More than 60 congressmen, most allies of Mr Uribe, are either already in prison or under investigation in Colombia for alleged links to paramilitaries. Last month, Mario Uribe, the president's cousin and close political ally, was arrested.

“The good news is that these paramilitary bosses could now face serious jail time,” said José Miguel Vivanco, Americas director of Human Rights Watch, a lobbying group. (In the United States, cocaine dealers can get 30 years or more.) “The bad news is they may no longer have any reason to collaborate with Colombian prosecutors investigating their atrocities...Just as local prosecutors were beginning to unravel the web of paramilitary ties to prominent politicians, the government has shipped the men with the most information out of the country,” he lamented.

In fact, the United States has agreed to allow Colombian prosecutors continued access to the extradited men. They have also apparently agreed to transfer to Colombia any seized assets or fines imposed on the warlords to compensate more than 100,000 victims who have come forward. Created in the 1980s by wealthy ranchers to protect themselves from attacks by the left-wing FARC guerrillas, the paramilitaries developed into armed gangs, accused of many thousands of killings as well as drug-trafficking and money-laundering.

Explaining his decision in a televised address on May 13th, Mr Uribe said the extradited men had violated the conditions of a 2003 pact with the government under which they agreed to surrender to the authorities in exchange for relatively light prison sentences—a maximum of eight years—and protection against extradition. In return, they had promised to confess to their crimes, cease all illegal activities and use their drug money to compensate the victims of their appalling crimes. But the 14 warlords had continued to run their criminal networks from prison and had failed to pay reparations, Mr Uribe said.

If the move was made with one eye on Washington, its timing appears to have been determined by a legal wrangle. Groups representing victims have been fighting to halt the extraditions. This appears to have prompted Mr Uribe's decision to send the paramilitaries to the United States. Colombia's Supreme Court had recently supported these groups, ruling that extraditions of paramilitary bosses should be carried out only after they had confessed to their crimes and paid reparations. But this was overturned by a judicial council last week. Within hours, the first paramilitary leader to be extradited, Carlos Mario Jiménez, alias “Macaco”, was on a plane bound for the United States, a journey made a week later by his 14 colleagues. More may follow.

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The Amazon

Marina marches off

May 15th 2008
From The Economist print edition

Brazil's minister for the Amazon resigns in frustration

AFP

The rainforest's defeated champion

WHEN Marina Silva was appointed minister responsible for preserving the Amazon five years ago, she gave a big boost to Brazil's standing among the world's environmentalists. All her adult life, she had been a prominent and uncompromising activist for the preservation of the rainforest, so the choice was a bit like picking a human-rights lawyer to run the police. But on May 14th she resigned—out of sheer frustration. Her departure will now make it a lot harder for President Luiz Inácio Lula da Silva's government to convince Amazon-watchers of its determination to slow the rate of deforestation.

Brazil has so many ministries—35—that tussles between them are endemic. But Ms Silva had become increasingly fed up with losing so many of her own. She lost out to Dilma Rousseff, Lula's chief-of-staff, in a row over environmental licences to build hydroelectric power plants on the Madeira river, the Amazon's longest tributary. She lost out to the agriculture ministry over the use of land in the Amazon region for farming. She was overruled in her opposition to the licensing of genetically-modified crops and again in her bid to quell the government's enthusiasm for nuclear power.

Then, in a move that was even more galling, Ms Silva was elbowed aside by Roberto Mangabeira Unger, a Harvard philosophy professor turned minister for long-term planning, who is sometimes gently mocked as Minister for the Future. Mr Unger, who is enthusiastic about big infrastructure projects in the Amazon, was handed the task of co-ordinating the government's plan for development in the region. “She accumulated so many defeats that she reached her limit,” says Roberto Smeraldi of Friends of the Earth in Brazil.

By getting out now, Ms Silva keeps her reputation intact and can return to the Senate, where she may say what she likes. She is such a well-known figure that finding a replacement will be hard. She grew up in the forest, where her parents were rubber-tappers. It was not until she was a teenager that she learned to read, going on to win a university degree before becoming Brazil's youngest senator when she was elected in 1994 at the age of 36.

The front-runner to replace her is Jorge Viana, a former governor of Acre, one of the states that make up the Amazon region. But Mr Viana is understandably nervous about taking over a ministry that appears to have been sidelined, particularly at a time when the rate of deforestation has speeded up. If Lula fails to talk a good candidate into accepting the job, Ms Silva's resignation will become an even bigger blow to his claimed good stewardship of the Amazon.

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Panama

The poor relation

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From The Economist print edition

A bid to inject new life into Panama's down-at-heel second city

VISITING the city of Colón in 1886, Gustave de Molinari, a liberal Dutch economist, noted that in comparison the worst parts of Genoa and Istanbul deserved a prize for good maintenance. Visitors today might award that prize to some of Africa's rundown cities. While Panama's economy is booming, its second city has not shaken off its tropical decay. That was what led the makers of the latest James Bond film to choose it as a double for a once war-torn Haiti.

Situated at the Caribbean end of the Panama Canal, Colón suffers an unpleasant combination of crime, poverty and unemployment. In the 1990s, its population shrank by a fifth (to 200,000). Of those who remain, only two in three have a proper job. On Front Street, the main drag, six blocks of elegant colonnaded buildings in the French style are falling down. Amid the neo-classical rubble, residents fend off afternoon boredom playing dominoes and slugging booze. Gang violence and the divorce rate are well above the norm.

Founded in 1850 when the isthmus became a route to the California gold rush, Colón's history is one of long periods of torpor punctuated by brief moments of prosperity. Many residents are the descendants of migrant labourers from the English-speaking Caribbean, brought in to dig the canal.

The city never really recovered from the closure of nearby American military bases after the second world war. A couple of these have found productive uses, like Manzanillo, a big container port, and the Colón Free Zone, which traded $16 billion last year. But others are derelict. Coco Solo, once a submarine base (and the birthplace of Senator John McCain), is overrun with squatters.

Panama's government hopes to inject new life into the city. Next year a motorway will link Colón with Panama City, the capital, for the first time. A Spanish-backed consortium wants to build a $40 billion energy hub. Other investors plan hotels and shopping centres.

The best hope of jobs for unskilled locals may lie in tourism. There are plans to spruce up local heritage sites and expand the airport. A cruise line is to start using Colón as a base later this year, allowing passengers to avoid visa hassles at Miami. But fear of crime may put off tourists in a city where better-off residents live in gated communities. One guidebook says bluntly of Colón “there is no good time to visit”. Economic development and better security will have to go hand-in-hand.

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Chile

Not so shiny

May 15th 2008 | SANTIAGO
From The Economist print edition

How an excess of political stability can get in the way of good government

Get article background

LONG regarded as Latin America's best-governed country, Chile has been tarnished lately by allegations of corruption and the mismanagement of public funds. At first the amounts involved were so small that they seemed to confirm the country's reputation for rectitude. Six years ago there was an outcry when $20,000 went into the wrong pockets at the Ministry for Public Works and Transport. The same ministry was later found to be using outsourcing contracts to boost the salaries of its civil servants.

Since then, however, the scandals have come thicker, faster and, in some cases, grubbier. They include charges of fraud, actual or attempted, in the government's sports-promotion agency, the state passenger-railway service and, most recently, the civil registry.

Yet the biggest blow to Chileans' faith in their public institutions was the discovery earlier this year of a hole of 263 billion pesos ($560m), equivalent to around 0.3% of GDP, in the education ministry's accounts for 2004-06. This led to the impeachment—the first of a cabinet member since the restoration of democracy in 1990—of Yasna Provoste, the education minister.

The case of the missing education funds actually looks more like incompetence than fraud. All the indications are that most of the money was paid, as it should have been, to schools in the capital, Santiago. But the inability of a ministry that spends close to a fifth of the government's budget to keep its books in order suggests that Chile's public administration, which just two years ago was described by the Inter-American Development Bank as one of the most efficient in the region, is not all that it is reputed to be. “I'm enormously worried by the signs of fatigue in the state apparatus,” admits Edmundo Pérez Yoma, Chile's interior minister since January.

The underlying problem, however, is that public spending has increased faster than the public administration's ability to spend money properly. The budget has grown sixfold since 1990, to $36 billion this year. Meanwhile civil servants are stuck with old processes and technology. The education ministry is a case in point. The accounting practices of its division responsible for payments to schools in Santiago have been under scrutiny for a decade, but it was only last year that it began to replace hand-signed cheques with electronic transfers.

Part of the trouble can be traced to Chile's inheritance from the dictatorship of General Augusto Pinochet, which lasted from 1973 to 1990. It bequeathed a knot of laws which have made it difficult to change the workings of the state and have entrenched them in the constitution. As sustained economic growth boosted the public purse, the government has found it easier to create ad hoc programmes that do not require congressional approval, rather than attempt the legislative challenges of restructuring the state in line with the demands that are now being placed on it.

Money money everywhere

This trick has proved so convenient that some of these programmes now have a larger budget than many government agencies, points out Rosanna Costa, an expert in fiscal affairs at Libertad y Desarrollo, a think-tank. Some of them do good things. One, Chile Solidario, is partly behind the country's success in reducing poverty. But, because they often involve several ministries, these programmes have tended to dilute normal accountability procedures. “The state no longer waters the playing field with a hosepipe, but with sprinklers on many sides and, on the way, leaks can obviously occur,” Ramiro Mendoza, head of the autonomous agency responsible for auditing the government, said in an interview with *La Tercera*, a newspaper, earlier this year.

Yet much of the fatigue can also be attributed to the Concertación, the centre-left coalition that has governed Chile since 1990. Now in its fourth term, the Concertación has become so accustomed to power that the idea of government as a temporary trusteeship of the state has been half-forgotten. Officials privately recognise that some state agencies have been captured by the parties that make up the government coalition; that they use them as a source of jobs for members who happen to be temporarily out of office; and see them as a potential source of election finance.

A law passed in 2003 to create a professional civil service has greatly reduced the number of political appointees in the public administration. When President Michelle Bachelet took office in 2006, she was allowed to appoint just 800 officials (out of a total of 160,000 in the central government administration), a quarter of the number appointed six years earlier by her predecessor, Ricardo Lagos—though even the new merit-selected professionals can still be dismissed at the whim of their political bosses.

But further remodelling of the state is needed if the government is to implement an agenda that includes better-quality state education and a big pension reform, which is due to come into force in July. Or, as seems increasingly likely, voters in next year's presidential election may conclude that the Concertación is part of the problem rather than the solution.

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China's earthquake

Days of disaster

May 15th 2008 | BEIJING AND DUJIANGYAN
From The Economist print edition

AP

Two natural disasters; two very different responses. We look first at the government's response to the earthquake in China, then at poor Myanmar

“DON'T cry, don't cry. It's a disaster, and you've survived,” China's prime minister, Wen Jiabao, told weeping orphans in a town almost flattened by the country's worst natural disaster in more than 30 years. Mr Wen's awkward words may have done little to calm the bereaved children. But amid the huge destruction caused by the earthquake of May 12th, China's leaders thus far have scored some unusual public-relations successes.

Hampered by poor weather (at least for the first day or two) and the blocking of mountain roads by landslides, Chinese troops have been struggling to rescue thousands of people buried in rubble and to bring aid to stricken communities across a wide area of the southwest on the edge of the Tibetan plateau. Three days after the disaster, officials put the number of dead at around 20,000, most of them in Sichuan Province north of the provincial capital, Chengdu. With many trapped, the toll could reach 50,000, the government said.

In contrast with neighbouring Myanmar's lethargic and secretive handling of its cyclone ten days earlier, China responded to the earthquake rapidly and with uncharacteristic openness. Within hours Mr Wen was on a plane, President Hu Jintao was chairing an emergency meeting of the Politburo's Standing Committee and thousands of soldiers and police were being dispatched. After an initial deployment of 5,000 troops the number was ramped up to 100,000 within three days. The official media, often reticent about reporting bad news, rapidly updated casualty numbers. State-owned television provided non-stop coverage.

During China's second-deadliest natural disaster of recent years, flooding along the Yangzi River that killed thousands in 1998, officials barred foreign journalists from some affected areas and failed to update casualty figures for two weeks, before providing suspiciously low numbers. Even this year the government was slow to respond to a snow disaster that affected much of south and central China in January. It expelled foreign journalists from Tibetan-inhabited areas (including the part of Sichuan now worst affected by the earthquake) after an outbreak of anti-Chinese unrest in March.

Of course, covering up was not an option. China measured the earthquake at a magnitude of 7.8, a force so powerful that it sent panicky office workers running into streets as far away as Beijing, 1,500km (930 miles) to the north. But China's leaders are anxious to repair the public-relations damage they have suffered internationally as a result of the Tibet crisis. And they are keen to avoid the kind of criticism directed at Myanmar.

Foreign reporters have been allowed into affected areas without hindrance by officials. China welcomed foreign aid in the form of material and cash. Japan said it was sending an earthquake team. President Hu discussed the disaster in a telephone conversation with George Bush and thanked him for American offers of help. Amid nationwide shock at the scale of the disaster, a recent upsurge of anti-Western sentiment triggered by events in Tibet appears to be abating.

Since March no Politburo member has publicly visited Tibet. Comforting earthquake victims, however, presents few political risks.

Mr Wen has remained at the scene to direct relief operations. Chinese television showed residents muttering “Thank you, prime minister, thank you,” after he declared to one group that thousands of troops and police had been deployed. Some victims are angry, but their resentment is directed at local officials rather than the central authorities.

In Dujiangyan, a large town about 50km from the epicentre, a woman in her 50s complains that while some buildings collapsed, the government and party headquarters remained intact. “Corruption and supervision of construction work is a problem, a very big problem,” says another resident. “I hope they learn a lesson from this.” Even the state-owned media have said shoddy construction may have exacerbated the impact. Casualties at schools have been high, partly because many were in classrooms when the earthquake struck in the early afternoon, but partly too, parents suspect, because they were badly built.

Hundreds of children were buried at Dujiangyan's Xinjian Elementary School, where a four-storey building collapsed like a pack of cards. One young woman, whose son had been killed at the school, was frantically trying to find out where his body had been taken. At one point she stood in front of an ambulance, sobbing and demanding information. Police came and took her gently aside and told her they would try to find the name of the morgue. Several ambulances plied to and from the site, but the official media have reported the rescue of only 50 or so children. Mr Wen watched two of them being pulled from the rubble and wept at the sight, said one Chinese report.

The victims' torch song

Officials are worried about damage to dams upriver from Dujiangyan, closer to the epicentre. Xinhua, a government-controlled news agency, has said Dujiangyan would be “swamped” if the nearby Zipingpu dam were to suffer major problems. Cracks have appeared on the dam's surface and workshops at the site have collapsed. The dam was completed less than two years ago despite concerns raised at the time about building it so close to a seismic fault line.

The Chinese media note that the government's decision to allow prompt coverage follows the implementation on May 1st of new rules on “government information transparency”. Under these rules, the authorities are supposed to make public any information involving the “vital interests of citizens”. But political calculations are likely to have played a bigger role than the regulations themselves, which still

allow information to be withheld if it relates to “state secrets”—a term applied sweepingly in China.

The Olympic games are a powerful incentive. The authorities rapidly decided to bow to public opinion and scale down the razzmatazz surrounding the parade of the Olympic torch through China in order to reflect the tragedy. Having at first suggested the torch ceremonies would continue as planned (they include a relay close to the disaster area next month), officials now say they will be “simplified” and combined with fund-raising for earthquake relief. A ritual that last month served as a red flag to China's critics may now be turned to much better use.

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Myanmar's cyclone

The regime is satisfied

May 15th 2008 | JAKARTA AND YANGON
From The Economist print edition

The junta lets a bit more aid in—but less than cyclone victims need

AFP

Still too little help for Myanmar's victims

Get article background

STARVING, homeless and vulnerable to infectious disease, the inhabitants of Myanmar's Irrawaddy delta must feel that things could hardly get worse. Almost a fortnight after cyclone Nargis struck, killing perhaps 130,000, the country's ruling military junta had not yet let in more than a trickle of humanitarian aid and was still barring most of the foreign aid workers and equipment needed to distribute it. Supplies were being delivered—or not delivered—at the whim of the army officer in charge of each district.

But unfortunately for the 2.5m or so survivors, things could indeed get worse. By midweek, heavy rains were hampering the meagre aid operations in the delta. And the outside world's attention and compassion was being diverted to the earthquake in China. A Russian rescue team quit Myanmar to offer its services in China, where they were welcomed.

Friends of the Burmese regime—China itself, India, Bangladesh and Thailand—were belatedly allowed to send a limited number of aid workers. Its arch-foe, America, was allowed to land military cargo planes in Yangon, the main city, this week. But the World Food Programme, the largest emergency-relief supplier, was managing to deliver less than one-fifth of the 375 tonnes of food a day that it reckons is needed on the ground.

The regime's leader, General Than Shwe, rebuffed repeated attempts by the United Nations' secretary-general, Ban Ki-moon, to speak to him by telephone. Admiral Timothy Keating, the head of America's Pacific Command, and Thailand's prime minister, Samak Sundaravej, both visited Yangon to try to persuade the regime to let in a big international rescue mission like the one assembled after the 2004 tsunami. Neither succeeded.

Myanmar's state news media made a big fuss about the dribbles of aid the regime did provide—and even some that it did not: the army was caught sticking labels with the names of top generals on aid that had been provided by Thailand. The UN said it was worried about aid supplies being diverted by the regime, though it had no hard evidence of this. Demonstrating its priorities, the generals sent enough armed troops to man checkpoints to keep foreigners out of the delta. Some Burmese drove out in their cars from Yangon to try to offer whatever help they could to their compatriots.

On May 10th the junta went ahead, in areas unaffected by the disaster, with a sham referendum on a new constitution designed to entrench its rule. It hailed a triumphant turnout, though its widespread intimidation of voters, to make them vote “yes” and stop them from urging a “no” vote, will render the

result—93% in favour—widely disbelieved. Even more absurdly, it is still talking of holding a vote on May 24th in the cyclone-hit areas.

Diplomats with access to the junta say it appears to be split between hardliners, led by General Than Shwe, who believe that the presence of foreigners will threaten their grip on power, and relative moderates—the most senior of whom is the junta's number three, Thura Shwe Mann—who recognise the gravity of the crisis and the need for international help.

European Union countries, meeting in Brussels, talked of getting aid to Myanmar by whatever means necessary. But they stopped short of backing an idea floated by France's foreign minister, Bernard Kouchner, of invoking a UN principle of the “responsibility to protect”, which evolved in the 1990s and was adopted by the UN in 2005. This says that national sovereignty may be overridden in extreme circumstances (see article). Britain and Germany were said to support the idea but any proposal would probably be blocked by China at the UN Security Council. Oxfam, a British aid charity, expressed doubts over suggestions this week that aid could be parachuted into the delta without the regime's permission: its spokeswoman argued that in the past such air-drops proved hugely costly and often failed to reach the most vulnerable.

Mr Samak's efforts notwithstanding, the response from Myanmar's neighbours in the Association of South-East Asian Nations (ASEAN) has so far been feeble. ASEAN admitted Myanmar in 1997, telling the West that sanctions against the regime were not working and that “constructive engagement” would achieve more. To judge from the cyclone, it has not.

ASEAN is planning to discuss Myanmar's emergency on May 19th and is promising to form a “coalition of mercy” to aid the country. But whatever, if anything, it decides, will be too little and too late.

The region's leaders, like the Chinese, are afraid that any intervention would set a precedent for outside meddling in their own affairs. Some are also loth to risk their considerable business interests in Myanmar. The $200m that the UN has appealed for, to finance aid to Myanmar, is a fraction of the hundreds of billions of dollars of foreign-exchange reserves the ASEAN members have stacked up. If ASEAN's leaders had quickly and publicly pledged substantial aid, even if it had not immediately been accepted, it might have shamed the regime into moving a bit further than it has. One of the many aid workers stuck in Bangkok this week, pleading with the Burmese embassy to grant him a visa, argued that by leaving so many people to die unattended, the regime was committing a crime against humanity. If so, that makes the country's self-interested neighbours accessories after the fact.

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Indian bombs

Blood in the Pink City

May 15th 2008 | JAIPUR
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Terrorists strike one of India's tourist capitals

AFP

Less lovely Jaipur

BICYCLES carry some extraordinary loads in India—bulging sacks of rice, grain, even coal. But the humble push-bike is earning a reputation as a terrorist's packhorse. On May 13th seven bombs exploded inside the old walled quarter of Jaipur, the capital of Rajasthan, and an eighth wreaked havoc outside a Hindu temple nearby. The blasts killed over 60 people and injured over 200 others. According to the *Times of India*, citing the state's police chief, several of the bombs were stowed on new Avon bicycles.

Jaipur, where buildings are washed salmon pink, the colour of hospitality, is a stranger to terrorism. It is the gateway to a state of amber forts and lake palaces that attracts about 10% of India's foreign tourists. But if terrorism is new to Jaipur, it has become depressingly familiar to India. Similar attacks struck other parts of the country in May, August, October and November last year.

These outrages are routinely blamed on jihadist groups such as Harkat-ul-Jihad-al-Islami, tied to Bangladeshi militants, or Lashkar-e-Taiba, whose spiritual leader sermonises from Pakistan. But according to Wilson John of the Observer Research Foundation, an Indian think-tank, India now has “a cocktail of terrorist groups, without any tag.” One called the Indian Mujahideen claimed responsibility for the attacks and released a video clip of the unexploded bike bombs.

Regardless of origin, the jihadists share a common aim: “to balkanise India,” as Mr John puts it. By attacking religious sites and festivals, they hope to provoke a backlash, which will in turn radicalise India's 150m Muslims, half a million of whom live in Jaipur district.

So far they have enjoyed little success. The day after the blast, the walled city was under curfew until 6pm. Boys played cricket on rooftops; old men played draughts or chess; hogs enjoyed an uninterrupted nose through the rubbish. The police had little to do: one examined a handful of ball bearings, which a bomb had turned into bullets. At 6pm, as the signal was given and the ropes were lifted, Hindus and Muslims alike reclaimed the streets to gawk at the damage and get back to business.

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Pakistan

The coalition collapses

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And a dangerous game begins

AFP

Somebody's happy with Sharif

THE spectre of instability haunting Pakistan will not go away. On May 13th the fledgling governing coalition of the Pakistan People's Party (PPP) led by Asif Zardari, widower of a former prime minister, Benazir Bhutto, and the Pakistan Muslim League (Nawaz), or PML-N, headed by another former prime minister, Nawaz Sharif, fell apart. Mr Sharif pulled out of the federal cabinet over "fundamental disagreements" on how to restore 60 senior judges sacked by President Pervez Musharraf during martial law last year. Not surprisingly, this raised fears of a yet another round of confrontation and instability. But all may not yet be lost.

Mr Sharif's party says it does not want to destabilise the PPP government and will not vote with the opposition. To do so, it suggests, would play into the hands of the "anti-democratic conspirators"—meaning Mr Musharraf and the Pakistan Muslim League (Quaid), or PML-Q, better known as the king's party, which is waiting in the wings to offer its coalition services to Mr Zardari. The coalition between the PPP and the PML-N in the critical province of Punjab is still hobbling along. And on May 15th, the Electoral Commission unexpectedly allowed Mr Sharif to contest a by-election, raising the possibility of his re-entering Parliament (previously, his election papers had been rejected). Pundits saw this as a sign that a deal may be in the works with Mr Zardari to keep the coalition going.

The stumbling block is the so-called "judges issue". Mr Sharif's party insists that the judges removed by Mr Musharraf should be restored by an executive order based on a parliamentary resolution. Mr Zardari's party claims that this would be unconstitutional, would lead to a clash with the president and current Supreme Court and that the army could be dragged in, with disastrous results. He wants a constitutional amendment that restores the judges without provoking a wider clash. Behind the legal sparring is hard politics, much of it personal.

Mr Sharif and his supporters want the old judges to return to throw out Mr Musharraf by declaring his presidential election last November unconstitutional. Mr Sharif would also like the judges to strike down his personal conviction for terrorism and kidnapping in 2000 which stands in the way of his seeking a parliamentary seat. In fact, he would like them to strike down pretty much everything Mr Musharraf did in his capacity as army chief and president—including the ban (enshrined in the constitution) on anyone serving as prime minister for a third term. The ban affects Mr Sharif who has been prime minister twice. But it would not affect Mr Zardari.

For his part, Mr Zardari has little reason to warm to the old Supreme Court judges. He served eight years in prison on charges of corruption and murder which were originally slapped on him by the government of Mr Sharif in 1997, though he was never convicted. By decree, Mr Musharraf exonerated both him and Ms Bhutto from criminal charges. The old judges struck down that decree. The new ones who replaced them upheld it. Mr Zardari therefore wants the new judges to stay on even after the old ones are reinstated. That would require the Supreme Court to be restructured by a constitutional amendment, with the aim of producing a balance of power between pro-Sharif old judges and pro-Zardari new ones.

At the moment, there is an impasse, The coalition in Islamabad has split. Yet if Mr Sharif is ensconced in Parliament soon, things may be patched up. Most Pakistanis want the coalition to survive in order to address pressing issues such as inflation, food subsidies, unemployment, power shortages and capital flight. America is also desperate to have a stable, legitimate government with which it can talk about

terrorism in Pakistan and Afghanistan. None of these worthy objectives would be met if the PPP and PML-N split apart, Mr Zardari cobbles together a coalition with the PML-Q—and the government is then besieged by political activists, lawyers and the stridently anti-Musharraf media.

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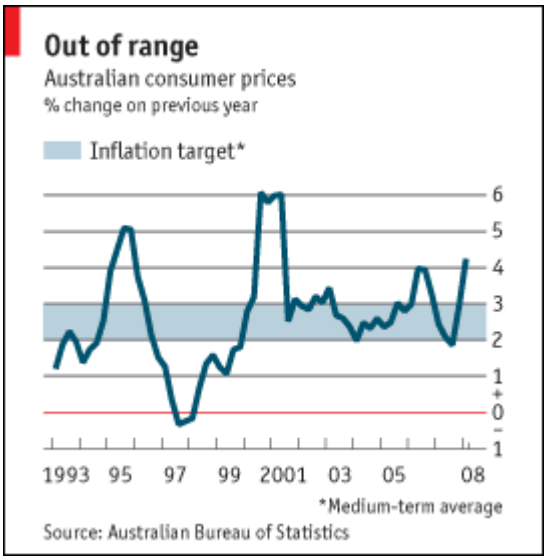
Australia

The lucky prime minister

May 15th 2008 | CANBERRA
From The Economist print edition

Kevin Rudd tries to be a prudent big spender

Get article background



WHEN he led the Labor Party to victory in November, Kevin Rudd, Australia's prime minister, boasted that he was a fiscal conservative. So when his government presented its first budget on May 13th, everyone wanted to see if he would remain true to that claim or to his other election promises to splurge cash on education, transport, health and the environment. In the event, Mr Rudd managed to do a bit of both.

Wayne Swan, the Treasurer (finance minister), announced a budget surplus for 2008-09 of almost A$22 billion ($21 billion). At 1.8% of GDP, it is the largest such surplus in almost a decade. Much of this bounty is the result of Australia's booming minerals trade with China. The Treasury calculates that soaring coal and iron-ore prices have improved Australia's terms of trade by 40% since 2004; by the end of this year, it says, the improvement will be around 70%. The resulting windfall surpasses even the bonanza of the 1950s, when Australia got rich from soaring wool sales during and after the Korean war.

But the latest boom has proved a curse as well as a blessing. It has helped drive inflation to more than 4% over the past year. In a bid to rein in the price rises, Australia's central bank has raised interest rates eight times in the past three years. On May 9th the bank gave warning that ever-improving terms of trade were putting more upward pressure on prices.

Mr Swan therefore had to make Labor's first budget in 13 years one that both tamed inflation and boosted the market's confidence in the new government. By one measure, at least, he succeeded. Rather than spend the latest surplus now, the government plans to park it, together with next year's forecast surplus (for a total of A$41 billion), in three funds earmarked for upgrading infrastructure, education and health. The idea is to roll out the invested money later, when inflation pressures have eased (and perhaps closer to the next election, due in 2010). The hope is also to avoid the criticism now raining down on the former conservative government that it squandered its windfall gains on tax cuts and other goodies. Stephen Antony, a former Treasure official, says the Howard government behaved like “drunken sailors”.

The budget predicts growth will slow next year and that inflation will drop slightly from 4% to 3.25%. But this is still higher than the central bank considers acceptable. Chris Richardson of Access Economics, a Canberra consultancy, worries about a “torrent of money” hitting Australia from fresh minerals deals with China. Mr Swan blames inflation and higher interest rates for unemployment, which is expected to increase to 4.75% next year. Yet the budget also assumes there will be an intake of almost 200,000 immigrants in the year; a record 133,500 will be chosen to meet employers' demands for more skilled people than they can find at home.

Mr Rudd claims the budget lays the foundation for the “greatest modernisation of the Australian economy in a long time”. For suburban Australians, heavily in debt from borrowing and spending their way through the good times, the real test will be its impact on inflation. The answer to that is still some months away.

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Sri Lanka

The war dividend

May 15th 2008 | TRINCOMALEE
From The Economist print edition

A flawed election in eastern Sri Lanka; a poor promise of peace or development

Get article background

AFP

Sri Lanka's face of democracy

WADING into Trincomalee harbour early on May 10th, a line of poor fishermen received election-day gifts from both sides of Sri Lanka's nasty, 25-year-old civil war. From the government, dominated by the Sinhalese majority, the gift was of a day's work. The government of President Mahinda Rajapakse had lifted a two-year ban on entering the harbour, an important naval base, just before the poll. From the rebel Liberation Tigers of Tamil Eelam (LTTE), who claim northern and eastern Sri Lanka, of which Trincomalee is the capital, there was a stench of diesel. This was all that remained of a naval transport vessel, the *Invincible*, which had been blasted and scuttled hours earlier by a "Black Tiger" suicide-diver.

Much was riding on the provincial poll. Last year, the government drove the Tigers from Sri Lanka's eastern province, which they had more or less held for over a decade. Defying international condemnation of its brutal methods, and a 2002 ceasefire that was officially scrapped in January, Mr Rajapakse's United People's Freedom Alliance (UPFA) promised to bring development and devolution to the "liberated" places. This week's election was the first test of its vow.

The government won. In alliance with the Tamil Makkal Viduthalai Puligal (TMVP) party—formerly the Tigers' eastern wing, a vicious militant group whose defection to the government had been crucial to its military success—it secured 20 of 37 seats. The main opposition, a coalition of the United National Party (UNP) and the Sri Lanka Muslim Congress (SLMC), won 15 seats. The TMVP's leader, Sivanesathurai Chandrakanthan, who is known as Pillaiyan, is now vying to be the province's chief minister.

That would be sadly appropriate. The government stands accused of committing dire human-rights and other abuses through its TMVP proxies. On election day independent observers reported many cases of voter intimidation and ballot-stuffing by still-armed Tamil militants. Curiously, in an election marked by widening ethnic and communal tensions, the TMVP's candidates won in several areas dominated by Sinhalese and Muslims.

In the two years since the government informally reignited the civil war—partly in response to terrorist attacks by the Tigers—several hundred young Tamil men have "disappeared" in eastern and northern Sri Lanka. The government says they must be among the war-displaced, of whom there are several thousand in India, 30,000 in the east, and perhaps 90,000 in the Tigers' remaining northern enclave. But human-rights groups and diplomats suspect that the government, through its militant proxies, is murdering its citizens.

Sumadhy, a fugitive living in a camp beside Trincomalee harbour, fears her husband is a victim. She says that on the evening of May 9th two men arrived and muscled him into a white van—the archetypal vehicle of abduction in Sri Lanka—in full view of a nearby army checkpost. Sumadhy says the soldiers there told her to report her husband missing at the local police station. "But I'm afraid they have killed him," she says.

Amid such atrocities, it is hard to celebrate the east's maiden provincial election. And as an exercise in power-sharing, it falls far short of the minimum demanded by Tamils and Muslims,

even assuming the government acts in good faith. Under a reform introduced in 1988, provincial assemblies are supposed to control land and policing. But these powers have not been relinquished by the government in Colombo, and there is little reason to think they now will be. The government will even pick the east's chief minister, either Mr Chandrakanthan or a defector from the SLMC, M. L.A. Hisbullah. Before the poll, it promised the job to both.

Unsurprisingly, many Tamils think the government is trying to subjugate them, not win them over. That is certainly its objective in the north. After declaring the ceasefire over, senior officials, including the army chief, General Sarath Fonseka, said the Tigers would be defeated this year. Perhaps that will be possible: the army is pitting 160,000 well-equipped soldiers against perhaps 10,000 self-trained LTTE rebels in a conventional war.

Yet after ten months of laying siege to the Tigers' enclave, the army has gained a few kilometres in the south-west, and little else. As a sign of its frustration, perhaps, on April 23rd the army launched a ground attack—which it called a counterattack—on the LTTE's northern defences. It failed as miserably as had several previous attacks. Insiders suggest 185 soldiers were killed.

With its superior numbers, the army can bear such costs. Meanwhile, General Fonseka says he is shelling the Tigers into extinction. Having estimated their strength at less than 5,000 fighters, the government claims to have killed around 3,400 Tigers this year. The remainder—however many they are—must be feeling the pinch. In the past 18 months the government may have sunk the LTTE's entire fleet of around ten cargo vessels. India has also redoubled its efforts to stem the supply of arms from its southern state of Tamil Nadu. In addition, shorn of the east, which supplied most of its ferocious child soldiers, the LTTE is reported to have doubled the levy it raises per family, to two recruits.

Under such pressure, the Tigers' appalling leader, Velupillai Prabhakaran, might try more drastic measures. Some fear a big increase in terrorist attacks—like the blast in a café in eastern Ampara that killed 12 people on May 9th.

The government might also try more spectacular attacks—for it, too, is under strain. According to a recent poll by the Centre for Policy Alternatives, a think-tank, a strong majority of Sinhalese supports the war. Only 16% said the government should negotiate with the LTTE. Yet this support is perhaps predicated on the government's promise to crush the Tigers swiftly. With much else to complain about, including soaring corruption and inflation at 25%, even the Sinhalese will not back this painful war indefinitely.

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Correction: Vietnam

May 15th 2008
From The Economist print edition

A couple of errors crept into our special report on Vietnam (April 26th). The new Intel facility is being built outside Ho Chi Minh City, not Hanoi; and Vinamotor plans to expand to the Dominican Republic, not Dominica. Sorry. These errors have been corrected online.

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Sudan and Chad

A bloody tit-for-tat

May 15th 2008 | KHARTOUM
From The Economist print edition

AFP

The Darfur disaster threatens to become even more of a regional catastrophe

PICKING through the knotted bundle of clothes in a police station in Omdurman, close to Sudan's capital, Khartoum, the security man emerges with a ragged cap in his hand. “Chad”, he says triumphantly, pointing to the flag emblazoned on its front. More rummaging produces a handful of identification cards, clearly recognisable as belonging to Chadian soldiers. He points to a row of shells on the ground; they too seem to come from Chad.

At dusk on May 10th, a rebel group from Darfur calling itself the Justice and Equality Movement (JEM) descended on the city of Omdurman, just to the west of Khartoum. Its target was the presidential palace, directly across the Nile. The attack was thwarted by government soldiers, who hastily blockaded the bridges. Within days, the assault had fizzled. But to the government in Khartoum, and to the Arabs who have run the country since independence in 1956, it was a terrible shock. It has dangerously widened a conflict that has been concentrated for the past four years in the western region of Darfur, where as many as 300,000 people may have died. And it raised the rare prospect of a conventional war between two African countries, Sudan and Chad.

Visibly shaken, President Omar al-Bashir wasted no time in appearing on television to denounce the attack and point an accusing finger at Chad's leader, Idriss Déby. The attack mirrored a rebel assault on N'Djamena, capital of Chad, three months ago. On that occasion, Mr Déby accused Sudan of meddling in its affairs, a claim that Mr Bashir flatly denied. Now the allegations and denials are reversed.

Though the dust cloud behind the rebel convoy roaring through Sudan's western desert should have warned of its approach, the government was plainly alarmed that such a ragtag bunch had come so far. Many Sudanese officials therefore assumed that the rebels must have had help, not only from Chad but also from certain people in Khartoum. Anyone suspected of links to JEM was immediately rounded up, including Mr Bashir's erstwhile ally, Hassan al-Turabi, the Islamist who heads the opposition Popular National Congress. Mr Turabi, who was later released, denies any involvement.

Apparent evidence of Chad's involvement came from a notebook said to have been found on a rebel. It not only meticulously lists the equipment the rebels were carrying and the number of people that began the long journey to Khartoum (1,231 soldiers in 191 land cruisers and pick-up trucks). It also apparently contains details of the rebels' last meeting, in Abéché in eastern Chad, before they set off.

Mr Déby denies that his government backed the rebels but a senior Sudanese foreign ministry official says that Chad's involvement goes all the way to the top. The Sudanese and Chadian presidents have

had rocky relations for several years, with each accusing the other of backing rebel groups across their own borders. In March this year the pair signed an agreement, promising to put past troubles behind them. But it turned out to be just another in a long line of broken pledges.

JEM's attack comes just a month after talks between the United States and Sudan started in Rome to explore ways of improving relations between the Sudan and Chad. The government in Khartoum had been negotiating with Abdul Wahid, head of the Sudanese Liberation Army (SLA), a separate rebel group in Darfur, so JEM may have felt it was being sidelined.

But for Khalil Ibrahim, JEM's leader, the attack was more than just a daring gesture. He apparently believed he could take the city and says he will try again. The rebels thought they would light a spark that could bring down the government; JEM promotes a national, not just Darfuri, cause. “They badly miscalculated, if that was the case,” says a prominent Sudanese commentator. Immediately after the attack, young Darfuri students from universities in Khartoum demonstrated against the government in the city centre but were quickly dispersed.

It seems unlikely that JEM's Mr Ibrahim will be able to attack Khartoum again soon. More than 100 rebels are said to have been killed in the city and 300 more arrested. As many as 200 may also have been killed in fighting in the desert before they reached Khartoum. If these estimates are correct, the rebels in and around Khartoum may now number around 600.

“The Sudanese government may be systematically rounding up suspected rebel or opposition supporters in Khartoum,” said Georgette Gagnon, Africa director for Human Rights Watch, a New York-based lobby. “Given Khartoum's record of abuse, there is grave cause for concern about the fate of those detained.”

The people of Darfur, who have suffered so many years in camps for displaced people in the remote desert regions of western Sudan, may now face another wave of reprisals. “We fear the Sudanese government will respond as it has in the past, with attacks against civilians in Darfur,” said Ms Gagnon. “Darfur needs the international peacekeeping force to deploy in full as quickly as possible.”

But the UN peacekeeping force which, in co-operation with the African Union, is supposed to deploy 26,000 soldiers to hold the ring in Darfur has so far mustered less than 8,000 soldiers. Astonishingly, it failed even to notice the rebel convoy heading towards Khartoum. The incursion from Chad will make its task even harder.

Don't forget the secessionist south

At least the peace accord of 2005 between the central government in Khartoum and the south is holding up, just. Salva Kiir, the southern leader who is also Sudan's vice-president, has roundly condemned the JEM raid. But trouble between the southerners and the northern-based government is brewing again. A dispute over the allocation of oil revenues and the demarcation of the boundary in the oil-rich Abyei region, which straddles the rough north-south line, has hotted up; several northern soldiers and southern ex-guerrillas were killed there this week. And most observers still doubt that the north will ever let the south secede, as the 2005 accord says it may, if southerners vote to do so in a referendum due in 2011.

With violent unrest continuing sporadically in west, south and even east, Sudan, Africa's biggest country by area, is finding it as hard as ever to stay together.

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Kenya

Looking more closely at the killings

May 15th 2008 | NAIROBI
From The Economist print edition

Can art make the politicians try harder?

THE torched body lies in the dirt, at the side of the road. Maybe it is a man; upturned, with charred hands and legs curled into claws, the face melted away to reveal yellow buckteeth, it looks more like a rodent. The charcoal skull is hatched with blade marks, perhaps the cause of death.

Such are the violent images on display at an exhibition called “Kenya Burning” at Nairobi's Go-Down arts centre, where some of the capital's poorest youths have been turned into brilliant dancers, artistic creators, and more. It has been debated whether it was too soon to remind Kenyans of this year's crisis, when at least 1,200 people were killed and 300,000-plus displaced. Others worried that the government would ban the explicit images. The show's curators, Judy Ogana and Joy Mboya, decided to try anyway, sifting through 2,000 photographs, most of them taken by Boniface Mwangi, a young Kenyan working for the local *Daily Standard*, and Yasuyoshi Chiba, a gutsy Japanese.

Arranged chronologically, from the happy lines of voters on the December 27th polling day through the fires and lynchings in the Dantean weeks that ensued, the harrowing images recall just how close Kenya came to anarchy. Fears of censorship have since subsided. The curators say the stream of ordinary Kenyans visiting the show has affirmed a renewed sense of nationhood. “There've been lots of tears and very heartfelt reflection,” says Ms Mboya.

The Go-Down is markedly trans-tribal. The young dancers come from all points of Kenya's ethnic spectrum, though most hail from the vast slums surrounding the city centre. The artists say their groups—for instance, the acrobatic Sarakasi dancers—have been brought closer together by the crisis, and they are trying even harder to reach out for recruits to the slums where the fighting was worst. Ms Ogana is a Kikuyu married to a Luo, a partnership of the two groups most at loggerheads in the recent crisis. Ms Mboya, a distant relative of one of Kenya's independence heroes, Tom Mboya, a Luo assassinated in 1969, is married to an Australian.

But not one Kenyan politician has visited the show. This has prompted calls by Kenya's artists for the images to be displayed in Parliament, even, say the feistiest, in the members' dining-room.

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Zimbabwe

The opposition goes for broke

May 15th 2008 | JOHANNESBURG
From The Economist print edition

Zimbabwe's opposition leader heads home to risk fighting another election

EPA

Morgan ponders his next move

AFTER a month on safari abroad, trying to befriend leaders all over Africa, Morgan Tsvangirai, leader of the embattled opposition Movement for Democratic Change (MDC), has decided to go home and risk contesting a presidential election run-off. As *The Economist* went to press, he was poised to fly back, having already missed at least one deadline to do so.

No one knows whether Mr Tsvangirai will be able, on his return, to move freely around the country. No one knows, more crucially, whether people will be able to vote freely or whether their votes will be honestly counted. Yet, though independent observers assume Zimbabwe's president, Robert Mugabe, and his people will do their worst on all such fronts, giving him a big built-in advantage in the contest, there is still a chance that a groundswell of opposition—and the courage and desperation of MDC voters—may give Mr Tsvangirai the edge, as it did in the first round. But few are confident he will win.

The electoral commission, which took over a month to announce the results of the vote on March 29th, has yet to set a date for the run-off. But it now says it may be held within 90 days after the date of the long-delayed announcement, ie, by the end of July. That, Mr Mugabe's backers presumably hope, should give them time to beat the opposition into submission.

Mr Tsvangirai, who says he won over 50% outright in the first round, accused the ruling ZANU-PF of rigging the official results, which gave him 47.9%, against 43.2% to Mr Mugabe. State-sponsored violence against suspected opposition supporters has been steadily increasing, so it will be harder for the MDC to contest a second round. The authorities have not excluded laying charges against Mr Tsvangirai, who hopes to address a rally in the Zimbabwean capital, Harare, on his return.

Repression is increasing. The editor of a prominent independent newspaper, a well-known human-rights lawyer and several trade-union leaders were arrested last week, as well as MDC officials. Foreign diplomats touring hospitals to investigate the violence were interrogated at a roadblock outside Harare. A few incidents of retaliation by opposition supporters have been reported, but pro-government militias have carried out most of the well-orchestrated violence, dishing out severe beatings and burning down houses.

The MDC says at least 32 of its supporters have been killed since March 29th. A doctors' association has documented over 900 cases of severe beatings-up by pro-government militias or members of the security forces since the election; it says the real number of victims, including women, children and the old, is probably much higher, as only a fraction of them reach hospitals, which are running out of basic supplies. Doctors and nurses in rural hospitals are being intimidated, so many victims cannot get treatment. Thousands of people accused of backing the MDC, including teachers and polling officials, have fled the countryside. They may not be willing or able to return to their original ward to vote in a second round, which would skew the results in favour of Mr Mugabe.

African leaders have called for a free, fair and peaceful run-off. The opposition wants more international observers and peacekeepers to come for the poll. Mr Tsvangirai wants the Southern African Development Community (SADC), an influential club of 14 countries, at least to double its number of monitors from the 120-odd who watched the first round and to send peacekeepers. But the government has said Western or UN monitors would not be let in, unless sanctions (in essence, a travel ban and asset freeze on some 130 leading figures of the regime), which are repeatedly blamed for the economic mess, are lifted. African

observers who monitored the first poll are to be let in again—and their numbers may even go up.

Be nice to a sweet old man

However, rather than give Mr Tsvangirai a chance of ousting Mr Mugabe at the polls, most regional leaders sound keener to arrange a negotiated settlement to produce a government of national unity, probably with Mr Mugabe at its head. That would be followed by a two-year transition and a gracious handover, perhaps to a compromise candidate within ZANU-PF.

South Africa's president, Thabo Mbeki, who remains the chief mediator for SADC, was in Harare last week, and sent a team including retired generals to investigate the reports of violence. It is unclear how much clout Mr Mugabe has over the Joint Operations Command (JOC), a secretive and influential clutch of Zimbabwe's security chiefs now chaired by Emmerson Mnangagwa, a ruling ZANU-PF hardliner widely touted as the likeliest successor to Mr Mugabe from within the establishment. The JOC is suspected of planning Mr Mugabe's fightback after the shock of his poor showing a few days after the March election and may be organising the violence.

Much still depends on the performance of SADC's observers and the attitude of its leaders. While Mr Mbeki is still doggedly loth to squeeze Mr Mugabe out, SADC's current chairman, Levy Mwanawasa of Zambia, and the chairman of the African Union (AU), Tanzania's Jakaya Kikwete, have become colder to the Zimbabwean leader, and may heed the suggestion that more monitors from other countries in Africa under the AU's aegis as well as from SADC countries be brought in. The head of South Africa's ruling ANC, Jacob Zuma, probably wants Mr Mugabe out. And Mr Mugabe's Chinese friends, foiled by southern African dockers who recently stopped a shipload of arms from reaching him, may be keeping their distance too. He is by no means certain of victory yet.

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Israel and America

Leaders united in the doldrums

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A sense of aimlessness as Israel celebrates its anniversary

GEORGE BUSH'S second visit to Israel in a year seemed even more pointless than his first one. Having come in January in a failed attempt to push forward the Israeli-Palestinian peace talks that he launched at Annapolis in November, he flew in this week to make a speech for the 60th anniversary of Israel's independence.

In any event, Mr Bush's influence since Annapolis seems to have been marginal. The two sides' negotiating teams have continued to meet, as have Mahmoud Abbas, the Palestinian president, and Ehud Olmert, the Israeli prime minister. People familiar with the talks even report warm relations and progress between the two leaders. But the Israelis have already downgraded the goal from a peace deal by the end of the year to a “framework agreement”, with no clues as to how specific that might be. Increasingly urgent American requests that Israel remove roadblocks and take other steps to improve life for Palestinians in the West Bank, where Mr Abbas holds sway, have been largely ignored.

Israel's conflict with the Islamist Hamas movement, which controls the Gaza Strip, grinds on, poisoning relations with the rest of the Palestinians and the Arab world, but America has shown no interest in what goes on there. It has been left to the Egyptians to try to negotiate a ceasefire and prisoner exchange, so far in vain. Hamas did its best to poison Mr Bush's visit with a rare rocket launch at the town of Ashkelon, injuring 90 people in a shopping centre.

In fact, Mr Bush's main contribution to peace this week was to try to shore up Mr Olmert, mired in the latest in a long series of corruption scandals, by describing him as an “honest guy”. That made many Israelis roll their eyes; Mr Olmert has had some of the lowest approval ratings in Israeli history, and 59% think he should step aside while the investigations are completed, according to a recent opinion poll.

There is no immediate sign that Mr Olmert will have to step down. The allegations are that when he was mayor of Jerusalem and later a minister, some of the campaign funds he received from an American businessman and fundraiser, Morris Talansky, were bribes, though it is unclear what the supposed bribers got in return. Mr Olmert's defence has been to lay responsibility for the handling of the money on his former law partner and confidant, Uri Messer, giving prosecutors the tricky task of proving otherwise. In any event, the prime minister is known as a political survivor.

What is more, Mr Olmert's political rivals are keeping their knives sheathed for now. Ehud Barak, the head of the Labour party, which plays second fiddle to Mr Olmert's Kadima in the coalition government and the man who could most easily bring the government down, would stand little chance of winning if an election were called tomorrow. The more likely contenders, Tzipi Livni of Kadima and Binyamin Netanyahu, head of the opposition Likud party, have also stayed mum about the scandal.

So Mr Olmert may survive long enough in his job to sign a deal with Mr Abbas. How much it will be worth is another question.

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The euro-area economy

Too good to last

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Illustration by Peter Schrank

A global slowdown, dearer oil, a strong euro and the credit crunch all start to bite

FOR a while, the euro-area economy seemed to make light of global gloom. Rising food and petrol prices crimped consumer spending, but firms in the euro area were contentedly working through order books fattened by resilient export demand. Perky business confidence, especially in Germany, helped drive the euro up, briefly over $1.60 in April.

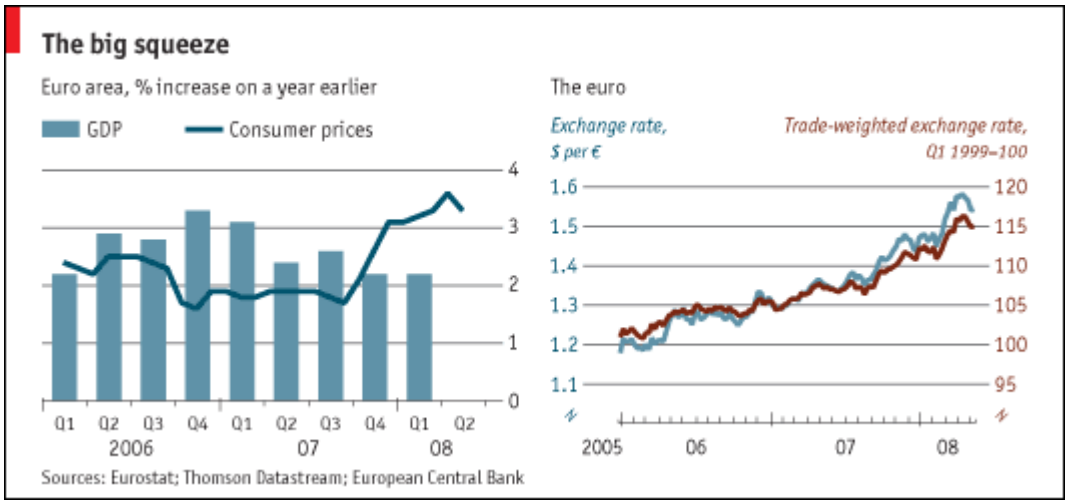
New figures show that the first quarter was surprisingly strong. GDP rose at an annual rate of 2.8%, far stronger than in either America or Britain. Solidity in the north made up for fragility in the south. Spain's growth was only 1.2%, making this its weakest quarter for over a decade. But Germany's economy grew by 6%, as construction firms took advantage of warm weather. France managed a solid 2.4%.

Yet this could be a high-water mark for the euro-area economy. Businesses have suddenly become a lot glummer. A bellwether survey of German firms by Ifo, in Munich, showed confidence dropping in April to its lowest in more than two years. French business confidence, which had briefly flowered, wilted as well; and Italian firms have sunk further into gloom. The monthly survey of euro-area purchasing managers showed manufacturing industry in April inching ahead at its slowest pace since August 2005.

That firms are feeling less chipper is not so surprising. Much of industry's earlier ebullience was founded on export sales, which made the euro area vulnerable to a global downturn. The malign effects of the credit crunch are now clearly visible in the euro area's biggest foreign markets, Britain and America. Even Germany's export engine is spluttering: shipments fell in February and again in March. Firms are now complaining more vociferously that the euro's strength is hurting demand.

Equally worrying is the fragile state of consumer spending, a drag on the economy ever since the credit crunch began last summer. Retail sales fell again in March, the fourth drop in the past six months, leaving them 1.6% lower than a year earlier. Sales in Spain—until recently a spending hotspot—were over 5% down on last year. German households seem unable to fill the gap in demand left by exhausted Spanish consumers. Even France, where demand seemed sturdy, saw falling sales.

Slow retail trade partly reflects a lack of spending power (see article). Household disposable incomes in the euro area grew by 3.8% at the end of last year but much of this modest gain has been eaten up by rising fuel and food prices that have pushed inflation well above 3%. Though euro-area unemployment is stable, nervous firms are creating fewer jobs. In Spain and Ireland, worst hit by the credit crunch, joblessness is rising.



Rising raw-material prices are a headache for policymakers, as well as a tax on consumers. Inflation fell from 3.6% to 3.3% in April, but hopes of further falls have been dashed by the run-up in oil prices above $120 a barrel. Unless the price of crude falls back, euro-area inflation is likely to stay above 3%, well over the European Central Bank's (ECB) target range of below 2%. Until inflation falls decisively, the ECB will not cut interest rates.

Nor is inflation the only worry. Credit conditions are tightening. Bank loans to households are growing more slowly than a year ago. A recent survey by the ECB revealed that banks plan new limits on their loans. Warier bank lending has contributed to a cooling in property markets, notably in Spain where house-price inflation has dropped to a ten-year low and housing starts have nearly halved since a year ago.

The credit crunch has had a less dramatic impact across the euro area than in either Britain or America. Bank lending to firms is still buoyant, though this partly reflects substitution for wilting capital-market finance. But Spain is suffering. “The Spanish economy is the clearest victim of the credit crunch, just as it was the main beneficiary of the credit boom”, says Michael Hume at Lehman Brothers. Spain is weighty enough—and its slowdown sharp enough—to do much harm to the euro-area economy.

There is one small reprieve: the fresh signs of economic weakness have curbed the markets' enthusiasm for the euro, which has now dropped back to $1.55. Yet few believe that the dollar will swiftly regain further ground. Whatever the frailties of Europe's economies, America is in even worse shape. A high and rising oil price, although harmful to Europe's prospects, hurts America's more. The euro area uses less oil per head, exports more to cash-rich oil-producers and has a healthier trade balance than America—all factors that favour its currency over the dollar. The ECB has a strict remit to keep inflation in check, so rising commodity prices are likely to keep interest rates high, lending further support to the euro.

A souring economy may just soften the ECB's hard line against inflation. At the start of the year, traders were betting that the central bank would start to cut interest rates by the middle of the year. Steadily rising inflation seems to have put paid to hopes of lower rates, at least for the rest of the year. The implacable ECB is one reason why tax cuts are on the political agenda. The new Italian government is talking of them. In Germany, the grand coalition is split between those who want to consolidate the fiscal position and those who want to cut taxes. Spain has announced a fiscal stimulus of 1% of GDP.

The economic news for the euro area seems unlikely to get better. Julian Callow, at Barclays Capital, reckons that GDP may not grow at all in the second quarter, as special factors that previously bumped up growth in Germany unwind. Figures next week may well show that Italy's economy has been flirting with recession. The worst of the credit crunch may be in the past, but there are tougher times ahead for the euro-area economy.

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France's cost of living

Purchasing-power disparity

May 15th 2008 | PARIS
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French shoppers want lower prices, but not more competition

Alamy

An expensive way of life

THAT coffee or cornflakes are cheaper in a German supermarket than a French one is bad enough. That French-owned products, such as Danone yogurt, Vittel water or Riches Monts cheese, are too is an affront. A basket of identical items costs 30% more in France, says a study by *La Tribune*, a daily.

Rising fuel and food prices are worrying consumers all over Europe. Concerns about purchasing power are an especially hot issue in France. President Nicolas Sarkozy's unpopularity owes much to his failure to boost it as he promised. Inflation, at a 17-year-high, is not the only problem. This week, he dropped in on a Yoplait yogurt factory to declare that "there is no reason why we should have the highest prices in Europe."

Yet if voters want lower prices, they are less enthused by more competition. Christine Lagarde, the finance minister, is promoting a new law to inject more competition into retailing. It would make it easier to build out-of-town hypermarkets, and would scrap a rule stopping retailers from selling below cost. In many places, hypermarkets have de facto local monopolies, and so are protected from competing with each other or with the big discounters, which account for only 13% of food retailing, next to 30% in Germany. Nor can hypermarkets negotiate freely with suppliers, which retailers say allows big brand-names to impose high prices.

So why are consumers not cheering on the new law? The Socialists say the fringes of historic towns will be destroyed. Deputies in Mr Sarkozy's own party, lobbied by food producers and small shopkeepers, want to dilute the text. When asked by Ifop, a pollster, how best to raise their purchasing power, only 42% of respondents picked out more retail competition. Some 85% preferred a cut in the sales tax, and 72% a rise in the minimum wage. Scepticism about competition has deep roots, ranging from a lingering influence of Marxism to a fear of American capitalism trampling the French way of life. Above all, voters see competition through the eyes of producers—as a menace to jobs and factories—rather than consumers.

This may explain why Ms Lagarde's new law does not touch other regulated areas, such as pharmacies, taxis and notaries. Supermarkets are still not allowed to sell non-prescription drugs. E.Leclerc, a hypermarket giant, was recently taken to court by pharmacists for running a television advertisement claiming that it could sell household medicines a lot cheaper if it were allowed to. The court ruling against the advertisement was overturned on appeal. But the pharmacists' monopoly remains—with Mr Sarkozy himself ruling out any change on the ground that pharmacies are not a business but a "public service".

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Russia's government

New jobs, old faces

May 15th 2008 | MOSCOW
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The line-up confirms that Vladimir Putin is still in control

AFP

Master and servant

ON MAY 12th, after almost a week of holidays, fireworks and celebrations, Vladimir Putin strode into his old Kremlin office and sat in his old chair opposite Russia's new president, Dmitry Medvedev. This was their first meeting since Mr Putin assumed his new job as prime minister. Yet the setting and body language had not changed at all. Mr Putin sank deep into his chair and spoke (first) to Mr Medvedev, who perched on the edge of his own. If you did not know that Russia has just had a change of president, you would certainly not have guessed it.

In the first week of Mr Medvedev's presidency, it was Mr Putin who made the headlines, leaving the new president to announce decisions and make introductions. Mr Putin's speech to the Russian parliament about the need to cut red tape, reduce taxes and modernise the economy was little short of a state-of-the-nation address. (Mr Medvedev's own such address has apparently been postponed until later in the year) Mr Putin also made several big appointments this week, transferring many of his old subordinates from the Kremlin down the river to the “White House”.

One such was to make Igor Sechin, the Kremlin's grey cardinal, who is often credited with the assault on Yukos and the subsequent takeover of its assets by Rosneft, an oil company he still chairs, one of five deputy prime ministers, and to put him in charge of industry. As well as Rosneft, Mr Sechin will chair the United Shipbuilding Corporation, one of several huge state holding companies set up in recent years. But Mr Putin has also kept in place his liberal economic team, including Alexei Kudrin, the long-serving finance minister. His first-deputy prime minister is to be Igor Shuvalov, an economically liberal and politically flexible former Kremlin aide.

Mr Putin has also shaken up the *siloviki*, the clan of security and military chiefs who served alongside him in the KGB. The head of the Federal Security Bureau, the KGB's successor, Nikolai Patrushev, has been pushed into a sinecure at the Security Council and replaced by a younger deputy. Mr Patrushev's rival, Viktor Cherkesov, who once called on all KGB men to unite, has been demoted. Even more significantly, Mr Putin has broken intimate (sometimes family) ties between the Kremlin administration, the FSB and the justice ministry. Vladimir Ustinov, a former justice minister and prosecutor-general, who provided legal support for the attack on Yukos (and whose son is married to Mr Sechin's daughter) has been shunted aside. Also seemingly sidelined is Viktor Ivanov, a hardline ex-spook who worked closely with Mr Sechin.

One explanation for reining in the *siloviki* is that they had become too powerful for Mr Putin's liking. Olga Kryshtanovskaya, a sociologist who studies the Russian elite, says that Mr Putin is cleansing the *siloviki* clan and getting rid of those who were equal or even senior to him in the KGB. “A tsar does not have colleagues, he has subjects,” she says. Hence also the demotion of Sergei Ivanov, a top KGB man and

defence minister who was a candidate for the presidency and cut a more independent figure than Mr Medvedev.

Mr Medvedev himself has made few independent appointments so far. Most of his presidential staff served under Mr Putin. Even his chief of staff, Sergei Naryshkin, a former deputy prime minister with presumed KGB links, will be as much a vigilante as an aide. The two specific choices made by Mr Medvedev are, however, significant. One is Alexander Konovalov, a fellow law student in St Petersburg, who will be justice minister. The other is Konstantin Chuichenko, an old university friend who will head the Kremlin's control department, a secretive and vital job that was once done by Mr Putin himself. Mr Chuichenko served in the KGB; he was also head of Gazprom's legal department and a director of RosUkrEnergo, a shady intermediary that sells gas to Ukraine.

Yet none of these changes, including even the shake-up of the *siloviki*, alters either the direction of Russia or the political system created by Mr Putin over the past eight years. He is well aware of Russia's colossal corruption, lawlessness and inefficiency; his recent speeches would befit an opposition leader. But he also believes that the system needs only upgrading, not replacing. Nothing in Mr Medvedev's behaviour so far suggests that he will fulfil the liberals' hope of a more open system.

Kirill Rogov, a political commentator, argues that the fake presidential election is unlikely to have altered Mr Medvedev's view of himself as Mr Putin's subordinate. His role as a “successor”, he argues, is not to steal power from Mr Putin, but simply to substitute for him and to look after his place while he is away on a business trip to be head of the government. When Mr Putin decides to return, Mr Medvedev will hand over the keys and receive a due reward for his service. But more than Mr Medvedev's loyalty, the system relies on oil prices continuing to rise and there being no crisis—and that is beyond even Mr Putin's power.

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Pipelines from Russia

Dead souls

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A gas pipeline and Soviet war graves

AS A sign of Russia's importance as a gas supplier to Europe and of its special relationship with Germany, few things beat the planned Nord Stream pipeline on the Baltic seabed. It was conceived in secret by a German-Russian consortium that is now headed by a former German chancellor, Gerhard Schröder. A Polish minister once likened it, perhaps intemperately, to the Molotov-Ribbentrop pact of 1939.

An Estonian member of the European Parliament, Andres Tarand, claims that the pipeline will also disturb Soviet war graves dating from naval battles in 1941, when forces occupying Estonia fled Hitler's advance. His sources include a classified Soviet military map of 1985, and work by an Estonian historian, Mati Oun, who calls it “the biggest marine cemetery in the world”. The Russians are sensitive about war graves and memorials, as they showed in a recent row about a statue in Estonia. But a Nord Stream spokesman insists that only one wreck is in fact anywhere near the pipeline route, and adds that it will not be disturbed. Who says energy politics is always boring?

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The Spanish opposition

Alone at the top

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Hard times for Mariano Rajoy, Spain's opposition leader

AP

Rajoy considers his position

IF LIFE can be lonely in politics, there may be few people as lonely as the leader of Spain's People's Party (PP). In March Mariano Rajoy lost his second election in a row to José Luis Rodríguez Zapatero's Socialists. Yet rather than step down, Mr Rajoy chose to stay on. His presence, he believed, would stop the PP engaging in self-destructive internal warfare. Next month he will stand for re-election. With nobody yet daring to oppose the man who controls the party machine, he should be a shoo-in.

Yet the fight he wanted to avoid has already broken out. Two former ministers, Ángel Acebes and Eduardo Zaplana, have abandoned him. The ambitious leader of Madrid's regional government, Esperanza Aguirre, is leaving open the possibility of challenging him. And now María San Gil, the popular PP boss in the Basque country, has rebelled, talking of “fundamental differences” with Mr Rajoy's new team.

Behind the scenes, a fierce ideological battle is being fought. Like Ms Aguirre, Ms San Gil thinks that Mr Rajoy is going soft. She frets that he wants to be nice to Basque and Catalan nationalists. She represents a wing of the PP that believes nationalists are intent on ripping Spain into separate countries. She accuses the Basque nationalists of moral cowardice towards ETA terrorists (who this week killed a policeman in a car-bomb attack). Her credentials as one who makes sacrifices for her party are second to none. In 1995 her colleague, Gregorio Ordóñez, was shot dead by an ETA terrorist in front of her in a restaurant.

A battalion of PP members has lined up behind Ms San Gil. They include Ana Botella, the normally discreet wife of Mr Rajoy's predecessor, José María Aznar, who is a senior member of Madrid's city government. “María San Gil is a moral, political and emotional reference point,” she said pointedly.

Mr Rajoy wants to push the PP to the centre. With no rival on the right, that seems sensible. In Spain, however, moving to the centre is not just a question of easing up on liberal economic policy. It also means softening the party's rabid opposition to further regional devolution.

Mr Zapatero's victory in March was due, in part, to Catalans and Basques who were scared into voting Socialist by the PP's aggressive centralism. Even if Mr Rajoy had won the election, the chances are that he, like Mr Zapatero, would have needed support from the nationalist parties in order to govern.

Yet PP hardliners may prefer ideology to electability. Ms San Gil is one of the few who could mount a credible challenge to Mr Rajoy. Young, charismatic and courageous, she would be a serious test for a man whose biggest weakness is that he was hand-picked by Mr Aznar as his successor and has never faced an internal challenge. Her biggest handicap is that (like Ms Aguirre) she does not have a seat in parliament. But her support for another challenger could prove decisive. The choice would then be between a new leader and new policies. The trouble is that the PP probably needs both.

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Serbia's election

Balkan end-game?

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The pro-Europeans did well, but it will still be hard to form a new government

THE partying went on late after Serbia's election on May 11th. Bucking the opinion polls, pro-European parties did better than expected, and the nationalists did worse. But the next morning brought the inevitable hangover. Voters have sharply altered the make-up of the next parliament, but left it split down the middle. Ljiljana Smajlovic, editor of *Politika*, a daily, concludes that “Serbia is not going to be a stable or happy country in the next year.”

The polls had predicted that the Radicals, the main nationalist party, would get a third of the vote, as would the pro-European coalition of President Boris Tadic. In fact Mr Tadic's lot took 39% and the Radicals only 29%. The smaller nationalist party of Vojislav Kostunica, the outgoing prime minister, also did badly. But the Socialists, the party of the late dictator, Slobodan Milosevic, did well, making them kingmaker instead of Mr Kostunica.

Several things affected voters at a late stage. On April 29th Serbia signed a stabilisation agreement with the European Union, usually the first step towards membership. More influential was the news that 17 European countries would no longer charge Serbs for visas; and that Fiat of Italy planned to invest €700m ($1.1 billion) in Zastava in Kragujevac. Fiat began making cars there in the 1950s. They now promise to create thousands of new jobs.

Ms Smajlovic calls the deal with the EU “a bribe”, but adds that Serbs do not care much. Resentment persists against EU countries that have recognised the independence of Kosovo, which Serbia still claims as its southern province. But more important was a fear that the door to the EU “might close if we don't move fast.”

The horse-trading over a new government will take weeks. What makes it harder is that local elections were held at the same time, so the talks involve municipal councils and the government of Vojvodina, a northern province, too. In the mix are lots of jobs on the boards of state companies, which bring patronage and cash.

Ivica Dacic, the Socialist leader, is torn. If he backs a government led by Mr Tadic's party, he may transform his own into a respectable social-democratic one. But most of his elderly, conservative supporters cast their ballots in the belief that they were voting against Europe. “Every solution will be bizarre and awkward,” suggests Braca Grubacic, a political analyst. Indeed, some mooted political bedfellows beggar belief. One permutation even has a small party of Muslim Bosniaks aligned with the Radicals, whose founder is on trial in The Hague for murdering and ethnically cleansing Bosniaks.

If the Radicals manage, despite their poor performance, to form a government, Serbia's European aspirations will be put on hold. But if Mr Tadic succeeds, which seems marginally more likely, friends of the Balkans in the EU will receive a big fillip (see article). They will argue that Serbia, Bosnia (which will soon sign a stability agreement like Serbia's), Montenegro and Albania should rapidly become formal candidates for membership; and that Macedonia, which is a candidate already, should be given a date for opening full negotiations.

One fly in the ointment is Ratko Mladic, the former Bosnian Serb general indicted by The Hague war-crimes tribunal. Some countries, notably Belgium and the Netherlands, say Serbia should not be rewarded until he is found and sent for trial. But their opponents say the fate of millions, whose countries are surrounded by the EU, matters too much to leave them hostage to Mr Mladic. There is a lot still to play for in the western Balkans.

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Charlemagne

Balkan exceptionalism

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Illustration by Peter Schrank

What Serbia's election says about the European Union's enlargement

A BRITISH tabloid set a high standard for bombast when it once took credit for the re-election of a Tory government with the headline: “It's *The Sun* Wot Won It”. This week European Union leaders were taking credit for another election upset: the unexpected success of the pro-European coalition led by the Serbian president, Boris Tadic, in the general election on May 11th. The Serbs had “clearly chosen Europe,” said the French foreign minister, Bernard Kouchner. Jan Marinus Wiersma, a Dutch member of the European Parliament, declared that the election was “a form of referendum in which citizens gave their support for the country's future membership of the EU.”

That may be a little premature. It is true that Mr Tadic's block is called the “Coalition for a European Serbia”. His supporters waved the EU flag of gold stars on blue. But Mr Tadic did not win outright, and it matters enormously which parties end up in a new coalition government. If the wrong parties cobble together a deal, they could yet lead Serbia into deeper isolation.

Yet it would be absurd to deny that the EU played a role in the election. European governments agreed to offer Serbia a couple of timely (if symbolic) concessions just days before the vote. Serbs may feel “humiliated” that 19 EU countries have recognised the independence of Kosovo after the province broke away in February, says a diplomat. But the EU also reminded them that Europe is about good things, such as freedom to travel. If it was not exactly the EU “wot won it”, European governments did at least send a signal that they would rather have Serbia in the club than brooding dangerously outside.

That holds true also for Serbia's neighbours in the western Balkans, who are being jollied along with visa concessions and the like, and assured that they enjoy a “European perspective” (to use the Brussels jargon for eventual membership). It all feels rather pragmatic, even generous. And that is odd, because when it comes to enlargement in general, older members of the club are in a foul temper.

It is not only the future that causes alarm. The mood is sulphurous over Romania and Bulgaria, which joined in 2007. Bulgaria has already seen tens of millions of EU funds frozen amid fears of fraud. The figure of suspended aid could rise to billions when a European Commission monitoring report comes out this summer. The new Italian government is talking menacingly about restricting Romanian migrants. The latest Eurobarometer poll on enlargement found majority support for the admission of only one new country: Croatia, a relatively advanced place whose beaches heave with sizzling Italians and Germans each summer. Croatia is on course to join in 2010 or 2011.

Even more paradoxically, some of the countries keenest on admitting Serbia and others have voters who are the most alarmed by enlargement. Migrant-phobic Italy led the way (together with Greece) in

arguing for the EU to be flexible over demands that Serbia co-operate with prosecutors hunting war criminals. Austria has lobbied tirelessly for Balkan bits of the former Austro-Hungarian empire, starting with Croatia. Yet Austrian voters now oppose admitting any Balkan country other than Croatia by large margins (and a whopping 81% are against Turkish membership). Similarly, French ministers may rejoice that Serbia's voters choose Europe, but in 2006 France was pushing the idea that future enlargement should be assessed according to the EU's “absorption capacity”, a dangerously vague term that includes voters' “perceptions”. The French president, Nicolas Sarkozy, is publicly against Turkey's membership.

If enlargement is so unpopular, why do so many EU leaders want the credit for Serbia's vote for Europe? There are two, linked explanations. The first is that holding the door open to Balkan countries such as Croatia, Serbia, Macedonia and the rest does not imply support for enlargement in general—it is a specific strategy for preventing further instability in Europe's backyard. And the second is that enlargement mostly works like that.

Consolidation, not enlargement

Arguably, enlargement as a general project does not exist. Moves to expand the EU are more often responses to particular crises, and they trigger big squabbles until it becomes clear that no better alternative exists (the 1995 expansion to take in Finland, Sweden and Austria being the exception). Greece was admitted in 1981 to bind it to the West, even though everybody feared it was not ready. It took nine years of argument to get Spain and Portugal in, amid cries of alarm (loudest in France) over cheap Iberian workers and farm produce. In December 1989, as Communist regimes fell across eastern Europe, the French president, François Mitterrand, proposed that ex-Warsaw Pact nations should be invited to join a loose “European confederation” (the idea died, not least because Mr Mitterrand invited Russia too). The EU hopes of Bulgaria and Romania only became plausible during the Kosovo crisis of 1999, when their airspace was needed to allow NATO jets to bomb Serbia.

Today's Serbia and the other Balkan applicants for entry may not be easy cases. But their admission does not pose “existential” questions for the EU, notes one diplomat, just a lot of hard work on building up clean, capable governments, in which scary nationalists are marginalised. Croatian negotiators even talk smoothly of “consolidation” rather than “enlargement” nowadays. Larger candidates for the EU, notably Turkey and Ukraine, cannot do that. They pose big questions, such as how to relate to the Muslim world or how to live with Russia.

The Serbian election could have been a lot worse. A thumping win for nasty nationalists would have seriously delayed EU expansion into the western Balkans. But supporters of admitting Turkey, say, should avoid premature congratulation. The western Balkans remains an exceptional case. Enlargement as a broader cause was not the winner this week.

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Gordon Brown's woes

A flimsy fightback

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PA

A darkening economy threatens the prime minister's bid to regain the initiative

WHEN Gordon Brown became prime minister last June, few doubted that it was his commanding performance in ten years as chancellor of the exchequer that made him the uncontested candidate. Yet in his astonishing fall from grace of the past few months, economic and fiscal stumbles have featured large. A haunting precedent is the short-lived administration of Anthony Eden, famed as a diplomat, who was felled by his mishandling of foreign policy in the Suez crisis of 1956.

This week Mr Brown sought to regain the initiative on what used to be his home ground. His most dramatic step was an astonishing fiscal volte-face to quell a Labour Party revolt against the abolition of the 10% income-tax band. That decision, revealed in Mr Brown's final budget but with effect from this year, returned to plague him because it made 5.3m poor households worse off. The government had agreed to try to help the losers at an expected cost of less than £1 billion ($2 billion). But on May 13th Alistair Darling, the chancellor of the exchequer, went much farther when he announced income-tax measures costing £2.7 billion in 2008-09.

The emergency fiscal statement, just two months after Mr Darling's budget, stubbed out the threatened rebellion by Labour's backbenchers. By raising the tax-free allowance, the chancellor will fully compensate 4.2m of the losers and help the remaining 1.1m. According to the Institute for Fiscal Studies (IFS), a think-tank, another 13m families will benefit too. Higher-rate taxpayers will not gain, since the threshold at which they pay tax at 40% rather than 20% has been lowered to neutralise the effect for them.

The chancellor stressed that the package, to be financed by higher borrowing, was for one year only. But he will find it hard to stand his ground, for any attempt to claw back the concession would antagonise many more people. The measure seems likely to join the list of one-off decisions that turn out to be permanent, says Robert Chote, director of the IFS. After a series of tax somersaults—on inheritance, capital gains, non-domiciled residents—it has left the government looking perilously inept and politically expedient a few days before a parliamentary by-election.

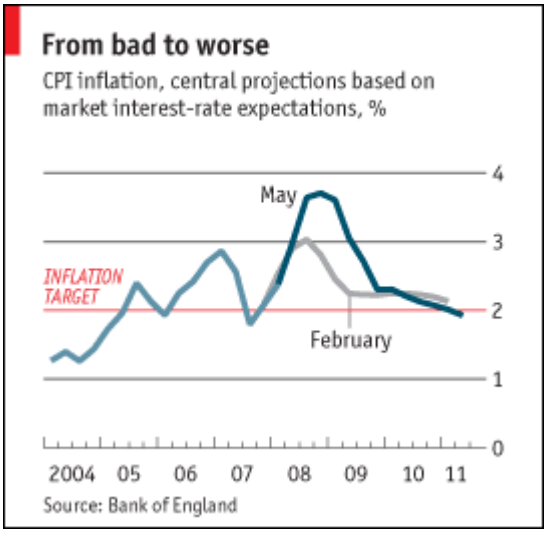
Mr Darling insisted that it was right to borrow more as the economy slowed. His case would have been a lot stronger if the public finances he inherited were in better shape. Even before this week's give-away the chancellor expected to have to borrow £43 billion—almost 3% of GDP—in 2008-09. Now that will rise to over £45 billion, and maybe considerably more as tax revenues from the troubled banking sector and floundering property market sag.

Mr Brown had something to say about the housing market when he outlined his legislative programme

for next year on May 14th. In this further attempt to regain the initiative, the prime minister highlighted steps to be taken to help first-time buyers. But the effect fell flat following the revelation a day before of the government's private fears about a faltering housing market. The briefing notes for Caroline Flint, the housing minister, which were photographed as she arrived in Downing Street, gave warning of “sizeable falls in prices later this year—at best down 5-10% year-on-year.” This assessment chimed with a report by the Royal Institution of Chartered Surveyors which showed that, judged by sales and prices, conditions last month were at their worst in 30 years.

It is not just the housing market that is in trouble; the wider economy is suffering too. On May 14th the Bank of England's quarterly *Inflation Report* painted a notably gloomy picture of the outlook over the next couple of years. The bank had already lowered its growth forecast appreciably in February, but now it has become even more pessimistic. Indeed its central projection is for growth of just 1% in the year to the first quarter of 2009, down from the 1.7% it thought likely in February.

But as growth falters, inflation is picking up. Consumer-price inflation jumped from 2.5% in March to 3.0% in April, and the Bank of England's central projection envisages it climbing to 3.7% later this year (see chart). Mervyn King, the central bank's governor, is resigned to having to write more than one mandatory open letter to the chancellor to explain an overrun greater than a percentage point above the 2.0% target.



The main effect of the surge in inflation will be to squeeze household budgets. Real incomes have already been under pressure for much of the past four years because of rising taxes and higher inflation. The squeeze is set to continue, said Mr King on May 14th, suggesting that real take-home pay would rise by less than 1% a year over the next two years.

Yet any relief that debt-laden consumers might hope to get from lower interest rates is looking more distant. The central bank generally looks forward two years when working out where rates should be. The trouble is that its forecast, based on market expectations of a cut in the base rate from 5.0% now to 4.5% in a year's time, shows inflation still above the 2.0% target in early 2010. This does not necessarily rule out further interest-rate cuts, points out Ben Broadbent of Goldman Sachs, an investment bank, since inflation is shown falling to the target a year later. But it may postpone them as long as consumer-price inflation is 3% or higher.

As the economy suffers from falling growth and rising inflation, it will be hard for Mr Brown to mount a sustained fightback. As Eden discovered, voters are especially unforgiving when a prime minister fails his special subject.

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Belize Bank

A $10m mystery

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What connects the deputy-chairman of the Conservative Party with Hugo Chávez?

MICHAEL ASHCROFT is a powerful man. A former treasurer of the Conservative Party, he is now its deputy-chairman. He is also a very wealthy man—the 65th richest in Britain, according to a rough-and-ready ranking by the *Sunday Times*. Through one of his companies, he has given over £3m ($6m, at today's rates) to the Tories in the past five years in cash and kind (including free flights for the leadership and opinion-poll research). Before the last general election, Lord Ashcroft lent the Tories another £3.6m.

As well as being powerful and rich, Lord Ashcroft is elusive: he is the right-wing pimpernel of British politics, whose name is uttered with awe and terror by Labour MPs. The mystery partly emanates from Lord Ashcroft's association with Belize: he spent part of his youth in what was then still British Honduras, subsequently returning to Belize to base some of his business activities there.

Belize is the smallest country on the American mainland, and one of the poorest in the Caribbean ("if the world had any ends," Aldous Huxley wrote of it, this "would certainly be one of them"). If Lord Ashcroft is an influential man in Britain, in Belize he is a colossus. His holding companies control, among other things, the country's biggest bank, Belize Bank. A strange tale involving that bank and Hugo Chávez, Venezuela's left-wing president, now risks embarrassing the Tory deputy-chairman.

At issue—and now under dispute in assorted ongoing court cases—is a $10m transfer from Venezuela to the government of Belize that has, in effect, ended up in the coffers of Belize Bank. The bank argues that the money it received constitutes repayment of a government-guaranteed debt; the current government says Belize Bank had no right to hang on to it and is suing to get it. The story revolves around a private hospital established by a company called Universal Health Services (UHS), with early financial backing from the government of the day and from Belize Bank.

The UHS hospital is today a surprisingly modest building in a suburb of Belize City. According to the Ministry of Finance, the firm borrowed money from Belize Bank in 1998 and then from various arms of the government, incurring debts that were transferred between government agencies as they rapidly mounted. It is unclear why the agencies and Belize Bank continued to lend relatively large sums over an extended period to such an unpromising enterprise, which was never able to meet its repayment obligations.

By December 2004, says the Ministry of Finance, UHS owed Belize Bank Bz$29m ($14.5m, or £7.7m). The prime minister of Belize, Said Musa, agreed to guarantee repayment of all UHS's obligations to Belize Bank (assuming a guarantee previously issued by Belize's Development Finance Corporation). The guarantee was signed by Mr Musa and by Francis Fonseca, the attorney-general. As court papers show, the guarantee was not disclosed publicly and the cabinet was not informed of it.

Further funds were advanced and UHS's debts continued to mount, to more than Bz$33m by March 2007, according to court submissions. A new agreement was reached on March 23rd 2007 in the form of a settlement deed and a loan note signed by Mr Musa and representatives of Belize Bank in the presence of Mr Fonseca. In it the government promised to repay UHS's existing obligations to the bank, beginning on April 23rd, and the former open-ended guarantee was discharged. Any disputes were to be resolved through arbitration in London. An additional loan facility for Bz$12m was agreed on March 29th.

The GDP of Belize is only $1.2 billion; many of its 300,000 inhabitants live in poverty. Illiteracy, shanty housing, gang crime and ill health are all sadly common (the annual budget of its health ministry is less than $40m). So you might think that there would be restraints on the government's ability to agree to what, in Belizean terms, was an enormous guarantee. In fact, there were: under section 7 of the Finance and Audit (Reform) Act of 2005, the government required the approval of the National Assembly. It was not secured.

By this time, the existence of the original guarantee had become known. The Association of Concerned Belizeans, a pressure group, and others filed suit to prevent the government from paying Belize Bank. Their lawyer, Lois Young Barrow, the ex-wife of the man who is Belize's prime minister today, argued that, according to the constitution, the 2004 guarantee should have been taken to cabinet. When the 2007 deal was revealed, she argued that it violated the 2005 finance act. Belize Bank, joined to the action as an interested party, tried and failed to quash it on procedural grounds. It maintained that whatever the status of the 2007 agreement, it was still entitled to its money. The government's solicitor-general undertook not to make any payments until the court case was concluded.

As payments from the government were not forthcoming, Belize Bank invoked the arbitration clause in the 2007 loan agreement and opened proceedings in London. The tribunal held that there was a dispute over which it had jurisdiction but got no further. By then, according to the party ruling Belize at the time, the unpaid debt totalled some Bz$45m.

As these legal twists and turns were pursued, general elections were nearing in Belize. The sitting prime minister, Mr Musa, was not favoured to win: he needed money to woo voters. As subsequent events were to show, Belize Bank was unlikely to be repaid after he left office. So the government looked for other solutions.

What friends are for

The first was to ask for a hand-out from rich and friendly countries. Taiwan agreed to help the government of Belize (one of the few countries with which the Taiwanese have formal diplomatic relations). On September 12th the Taiwanese paid a (US) $6m cheque into an account held with Belize Bank in the Turks and Caicos islands, and on October 20th another cheque for $4m was deposited.

Oil-rich Venezuela also obliged. On December 28th the central bank of Belize received $10m from Venezuela, wired via the Federal Reserve Bank in New York. In January Venezuela's generous gift, for housing and a sport stadium, was disclosed to a grateful nation; a general election was announced and cash frantically dished out to eager voters.

Unbeknownst to the public, however, another $10m pursued a more winding path from Venezuela to Belize. As court papers show, the funds were transferred on December 28th by the Banco de Desarollo Económico y Social (BANDES), Venezuela's development bank, to Belize Bank's account with its correspondent bank in London, Bank of America. The transfer contained (in Spanish) the instructions “Single disbursement [to]GOB (ie, the government of Belize) [for] construction and repair of housing”. On January 24th the money joined the Taiwanese funds in the Turks and Caicos islands.

While this aid was being wrung from public donors, a private-sector buyer for UHS was also sought. Dr Muthugounder Venugopal was the man eventually fixed upon. He and his associates ran the Loma Luz hospital in Belize—and he reportedly raised Bz$5m in the form of a loan from Belize Bank. A bewildering array of trusts and companies and a joint venture variously registered in the British Virgin Islands, Turks

and Caicos, and St Kitts and Nevis was used to convey much of the money thus assembled to Belize Bank. On January 30th Belize Healthcare Partners, owned by a joint venture essentially between Dr Venugopal's Venny Group and a new Belize Healthcare Charitable Trust, paid Belize Bank Bz$39m—almost the combined total of Taiwan's grants and the secret transfer from Venezuela—to buy UHS's assets, and a further Bz$6m to other creditors and suppliers.

This secret Venezuelan transfer was not made public—until Mr Musa, despite the hand-out, lost the election on February 7th: he is now threatened by a host of corruption allegations, including some involving dodgy loans by development agencies. The day after he was swept from power, the new rulers of Belize were, they say, asked by Venezuela for an accounting of its $20m gift. The central bank of Belize demanded that Belize Bank hand over the Venezuelans' second $10m and display its authorisation for not coughing up the Taiwanese funds. In its report on the matter sent to Belize Bank on March 31st it charges the bank with various irregularities. For its part Belize Bank has challenged in court the central bank's directives.

The government of Belize, under its new prime minister, Dean Barrow, wants good relations with Belize's largest commercial bank and with Lord Ashcroft. But it also wants what it sees as its money back. On April 10th the government sued the bank for the return of the Venezuelan $10m. (Referring to the former government's secret agreements, Mr Barrow told the assembly on April 25th that “The days of doing things in the dark behind the backs of the Belizean people in order to screw the Belizean people are over.”)

What is the truth of the matter? Philip Johnson, the chairman of Belize Bank, says in a letter to *The Economist* only that “a further settlement was reached which allowed monies to be made available for the purchase of the assets of UHS.” He insists that the guarantees were legal, and claims that Belize Bank in fact received less than it was entitled to. As to the transfer instructions from Venezuela specifying that the funds be paid to the government of Belize for housing, his bank “was not privy to the arrangements between the Governments of Belize and Venezuela” (though, as the deposit was made into Belize Bank's correspondent account in London, it seems odd that the bankers should have been unaware of Venezuela's instructions).

A different interpretation is summarised by Mark Espat, a minister under Mr Musa who lost his cabinet job for opposing the guarantee. Money, he says, was “diverted from its intended purpose to honour a debt that should never have been agreed in the first place”.

They seek him here, seek him there

Lord Ashcroft's Belizean existence has caused him trouble before now. When he was ennobled in 2000, the Tories said he would assume permanent residence in Britain—fulfilling the inverted principle of no representation without taxation. His nomination for a peerage had previously been rejected, partly, it is thought, because of his tax status. It remains unclear whether that pledge has been fulfilled; his attendance in the Lords has been infrequent. And as the UHS row demonstrates, he is as controversial a figure in his adoptive homeland as he is in what is theoretically his real one.

The Economist sought his comments on Belize Bank's involvement in the affair, but none has been forthcoming from him or from his aides. So Lord Ashcroft's own role in the matter, if any, remains unclear. But Belize Bank is owned by a holding company of which he is the majority shareholder and executive chairman. His son runs Belize Bank in the Turks and Caicos.

Meanwhile, Lord Ashcroft and his fortune continue to exert huge influence on British politics. Exploiting a clause in party-funding laws that allows unlimited campaign spending before an election period, he is funding aggressive campaigns by prospective Tory candidates in key marginal constituencies—a tactic that reaped big benefits at the 2005 election.

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Crewe by-election

A little local difficulty

May 15th 2008 | CREWE, CHESHIRE
From The Economist print edition

Labour tries to defend a once-safe seat

THE town of Crewe, in north-west England, is used to outsiders. It had a population of just 70 in 1831 but grew rapidly when it was chosen by the west-coast railway as the location for its engineering works. Along with its more bucolic neighbour, Nantwich, it now forms a parliamentary constituency of roughly 100,000 people. Both will be inundated by visitors of the political rather than industrial variety until May 22nd, when a by-election is scheduled to replace Crewe's previous Labour MP, Gwyneth Dunwoody, who died on April 17th.

Labour has a comfortable majority in Parliament, so the significance of the by-election is symbolic. It is no less important for that. Were the Conservatives to win, their first by-election gain since 1982 would quicken momentum built up by months of large opinion-poll leads and a strong showing at the local elections on May 1st. To overturn Labour's majority of 7,078 in Crewe, they need to change the minds of 8% of the electorate. A similar national swing at a general election would give them a solid parliamentary majority.

Worried, the Labour Party has dispatched senior figures, such as John Hutton, the enterprise secretary, and Harriet Harman, its deputy leader, to campaign in the constituency. David Cameron, the Tory leader, visited the local police station on May 12th—his second trip to Crewe in a week. Even Nick Clegg, leader of the Liberal Democrats, dropped in on May 9th, although his party's candidate hasn't a hope of winning.

Predicting the result is a fraught game. Both Labour and the Tories are cannily playing down expectations. At the local elections on May 1st, voters in Crewe and Nantwich backed the Tories over Labour by 45% to 29%. But an ICM poll on May 11th showed the Tories leading Labour by only 43% to 39%, with the Lib Dem candidate, Elizabeth Shenton, on 16%. This is partly because Ms Dunwoody's huge popularity is rubbing off on her daughter, Tamsin, airlifted in from Wales to fight the seat for Labour. Her Tory rival is Edward Timpson, a young lawyer whose family own a national chain of shoe-repair outlets.

Colourful campaigning on Labour's part may also have played a part in containing Tory momentum. Some activists are dressing up in top hats (a dig at Mr Timpson's privileged background); others follow Mr Cameron around in hooded tops imploring him to hug them—a reference to his call in 2006 for more sympathy for young delinquents. Labour is gambling that such a nuanced take on crime goes down less well in gruff northern towns than in liberal enclaves of London.

But crime is not the main source of local grumbles. And though shopfronts betray a recent influx of eastern Europeans—the resoundingly English-sounding Duke of Bridgewater, a tavern near Crewe's town centre, is now a Polish pub and restaurant—neither is immigration. Locals rub along with the newcomers well enough, and no candidate from the far-right British National Party is standing.

Instead, voters are animated by kitchen-table concerns about the economy. The government's unpopular removal of the 10% starting rate of income tax affected many low-earners in the constituency; Labour's performance will depend in large part on whether voters are impressed by the government's climbdown on May 13th. Long-promised regeneration projects have stalled, leaving empty dwellings in the poorest parts of Crewe to fester. The vulnerability of manufacturing jobs (Bentley, the luxury-car firm, is based nearby) is a worry that never goes away. And Royal Mail, another large local employer, may move Crewe's postal sorting office elsewhere.

However local the grievances aired on the doorstep, the impact of the electoral result will extend all the way to Westminster. A northern and relatively safe Labour seat would be some scalp for Mr Cameron to claim. But if Labour scrapes home it will certainly relieve the strain on Gordon Brown, the struggling prime minister. The stakes are undoubtedly high; whether politicians trying to seduce the people of

Crewe will remember their concerns beyond May 22nd is less certain.

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Commanding heights (1)

A check on the mail

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From The Economist print edition

Royal Mail struggles to compete in a liberalised market

A MORE remote part of Britain would be hard to find than the small Shetland island of Foula. With a population of 30, it lies across 17 miles of angry Atlantic Ocean from its nearest neighbour. Getting to it is not easy. One can catch a ferry (assuming the waves are not too high) or take a plane, if the wind isn't too harsh.

Delivering mail regularly to the 21 addresses on the island is as difficult. Although the island is one of a handful that do not get post delivered six times a week (by special exemption, its mail comes only three times a week, usually when the ferry is running), that is the only concession granted to Royal Mail, the state-owned postal company. No matter how much it costs to deliver letters to Foula, Royal Mail can charge no more than the standard rate of 36p for a first-class letter. This “universal service” of mail deliveries to all parts of the country for a single price is one of Royal Mail's proudest achievements. It is also its Achilles heel.

Two years ago Britain ended Royal Mail's 350-year monopoly and bravely opened its mail market to competition. It hoped that the bracing wind of competition would force Royal Mail to pull up its socks. The tired old firm, once a sinew of empire, was suffering from woeful industrial relations—workers not only went on strike regularly, but on any given day 7% of them were missing—and decades of low investment. Whereas Germany's Deutsche Post uses machines to sort 89% of letters, Royal Mail gamely sorts half its letters by hand. The government reckoned that in 2002 the American postal service got 25% more work done per employee than Royal Mail did, and that Deutsche Post was 9% more productive.

For Royal Mail, with all its inherited problems, catching up will not be easy. With a £3.4 billion pension deficit, the company is struggling to find cash to invest in new machines. And it thinks it is 40% less efficient than new entrants to the British market, which have started from scratch and put in the newest machines. Without established unions to fight, newcomers are also able to pay their staff some 25% less than Royal Mail does.

In the two years since the government opened the postal service to competition, Royal Mail has rapidly lost market share. About 20% of all letters posted in Britain are now collected by its competitors. So are some 40% of those posted in bulk by large companies such as banks and energy firms. This far exceeds the 5-10% of the market that even the biggest fans of liberalisation expected new competitors to take.

For big customers the benefits are clear. Large firms are paying up to 3% less in postage than they were in 2005, and some think prices across the whole market are 5% lower than they would have been without competition. But others may suffer, for the success of Royal Mail's rivals threatens the viability of its universal service. Royal Mail posted its first-ever loss (of £100m) on this service in the year to March 30th.

Postcomm, the postal regulator, reckons the only solution is more liberalisation. On May 15th it recommended partial privatisation of Royal Mail. It hopes to avoid another option: cutting back its universal service. “We have to ask whether we really need to get our mail delivered every day,” says Paul Jackson of Triangle, a consultancy specialising in postal services.

Privatising Royal Mail, or reducing the universal service, seems certain to arouse public anger. Already government efforts to reduce the subsidy for the post office, which may see the closing of more than 2,500 branches, have run into widespread opposition. On May 14th local-government representatives met to discuss ways of using council budgets to keep post offices open; Essex County Council has set aside £1.5m in the hopes of saving 15.

A better idea than using public money to prop them up, however, would be making them profitable. One idea that is gaining ground is putting post-office counters in pubs, another amenity under threat in many small villages. Both stand to benefit from an increase in the passing trade, and trademark queues at the post office, instead of making customers grumble, provide a welcome excuse for a pint.

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Commanding heights (2)

Nuclear diplomacy

May 15th 2008 | SIZEWELL, SUFFOLK
From The Economist print edition

British Energy proves a slow sell

EVEN today, 13 years after it was built, Britain's newest nuclear-power station looks futuristic, with its landmark white containment dome and the blue haze of Cerenkov radiation in the cooling pond. In contrast to the huge furnaces needed to burn coal, a reactor core at Sizewell B roughly the size of a smallish lorry produces 3% of Britain's electricity. But its construction was so controversial—sparking one of the longest planning inquiries ever—that, after it was finished, nuclear power was abandoned for a generation.

Now, worries over climate change and the end of self-sufficiency in oil and gas mean that atom-splitting is set for a comeback. Ministers want new plants to boost nuclear power's contribution above the 18% of electricity it currently provides but insist that, unlike in the past, there will be no subsidies. With that in mind, the government announced in March that British Energy, which owns most of Britain's nuclear plants (including Sizewell B), was up for sale, and with it the state's 35% stake.

In theory, the firm is an attractive proposition. Despite its troubled history (a government bailout in 2002 saved it from bankruptcy), it is well placed to take advantage of any nuclear renaissance. The appeal lies not in the firm's mainly elderly power plants but in its land. Public support for nuclear power tends to be highest near existing reactors, which are big employers, and there is ready access to cooling water and the electrical grid.

So far, though, there has been no scramble for it. By May 9th, the unofficial deadline for bids, only EDF, a French utility and nuclear enthusiast, had made an offer, which was to be discussed at a British Energy board meeting on May 15th and 16th. Other companies such as RWE, a German firm, and Spanish Iberdrola are said to be interested; they could submit bids in the coming weeks. Besides the usual business considerations, there seem to be two particular worries affecting the sale.

The first is economic nationalism, a force long thought absent from the corridors of power. Foreigners have been blithely permitted to buy firms in Britain that other countries would regard as strategic; most recently Ferrovial, a Spanish company, acquired BAA, which owns Heathrow airport. But some sense that letting foreign firms build the next generation of nuclear-power plants is now coming to be seen as a globalised step too far.

Such worries could explain why Centrica, a British electricity firm, has repeatedly been linked to the sale. The parent of British Gas, it is exposed to fossil-fuel prices and keen to diversify. But it is hard to see what it has to offer British Energy.

It takes a lot of capital to build nuclear plants, and almost nowhere has the private sector on its own provided it. A big European company such as EDF has the financial clout to pay for at least one new plant from its balance sheet, a proof-of-concept that British Energy hopes would attract cash for subsequent stations from the financial markets. Centrica—whose revenues of £16.3 billion look puny compared with EDF's sales of €60 billion (£40.8 billion)—would find that approach much harder. But it is British; and sources close to the negotiations talk of a possible joint venture, providing European cash with a Union Jack draped around the deal.

The other worry is competition. British Energy operates all but two of Britain's nuclear plants, and with those due to close by 2010 it will soon have a monopoly. British Energy is not the only entry point for would-be providers of nuclear power—the government plans to sell land it owns around older, decommissioned reactors as well. But there is nevertheless talk of either dividing the firm or forcing it to sell off some of its unused property to stimulate competition. Buying that land could be more attractive than acquiring British Energy itself, since the new proprietor would not be burdened with running down existing plants.

Insisting on having more than one supplier is probably a good idea, although there are strong arguments that economies of scale are vital to making nuclear energy affordable. And if there are several competitors, what does it matter whether a few are fully foreign-owned?

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Bagehot

The hardest word

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Illustration by Steve O'Brien

Frank Field, the fight-back and the virtues and limitations of apology

TWO apologies were made in the House of Commons on May 13th. The first came via a startling announcement from Alistair Darling, the chancellor. The other was made by a humble backbench Labour MP, Frank Field. His was unquestionably the more gracious: concise where Mr Darling's was waffly, blunt where the chancellor was periphrastic. It is just possible that Mr Field's apology will also turn out to be the more important.

Status is an odd commodity in politics. There are some cabinet ministers—Mr Darling is one of them—who combine nominal eminence with bland invisibility. There are some MPs, on the other hand, with little formal authority but high renown, sometimes derived from peccadillos or eccentricities, in a few cases from their intellect or principles. Mr Field is one of those. His latest bout of disproportionate prominence came as leader of a backbench tax rebellion. That threatened to torpedo the government; there is a chance, if a slim one, that his apology may prove a symbolic turning-point in Gordon Brown's premiership.

Je regrette everything

In some ways Mr Field isn't symbolic of anything. His idiosyncratic views—on Europe and immigration, for instance—have led some of his colleagues to regard him as a crypto-Tory. His saintliness rubs some people up the wrong way. But he has spent decades thinking and campaigning about poverty and inequality. That made him a natural front man for Labour MPs who revolted over the abolition of the 10% tax rate, which hurt several million low-income households. As Mr Field put it, the 10% ruse violated the implicit contract between the New Labour modernisers and their parliamentary foot-soldiers: look after the needy, the rank-and-file said, and we'll trust you on the rest.

Quirky though he is, Mr Field is a good example of another common disillusionment: among thwarted or discarded ministers. His own ministerial career was short and not especially glorious. In 1997 Tony Blair gave Mr Field a brief to “think the unthinkable” on welfare reform; just over a year later he was sacked—in part because his passionate opposition to means-tested benefits contradicted Mr Brown's enthusiasm for them. It is fair to say that, as with some other casualties of the Blair-Brown era, the hatchet has not been buried.

Except, that is, in Mr Brown's back. Mr Field harried the government to make good the 10% tax losses;

he carried on harrying it after Mr Darling made desperate but skimpy concessions. Then he attacked Mr Brown himself: he would be very surprised, he said, if the “unhappy”, tragic prime minister were still Labour's leader at the next general election. It was for this that Mr Field said sorry: “I apologise”, he said, “without reservation”. It was brave and might have been moving, had not the Commons predictably erupted in whoops and mockery.

On the face of it, this vignette was rather less momentous than Mr Darling's statement. In it the chancellor raised the threshold at which income tax is paid: most of the 10% losers, and all basic-rate taxpayers, will be £120 ($240) better-off this year. It was an emergency mini-budget, designed to defuse Mr Field's rebellion, and buy forgiveness from the voters of Crewe, where there is an ominous by-election on May 22nd. The cost—£2.7 billion—will take the government perilously close to its avowed borrowing limit (the Tories, not unreasonably, are calling Crewe the most expensive by-election in history). Mr Darling and Mr Brown had previously said that it was too late to amend this year's tax arrangements, and that the Treasury was too skint for splurges. They now look desperate, cynical and chaotic.

For all that, Mr Field's contrite cameo may, in its way, prove a more crucial moment: the moment (so Mr Brown will hope) at which Labour MPs drew back from the abyss.

As the latest batch of Blair-era memoirs, from Cherie Blair, and others, again attests, the history of New Labour is a chronicle of feuds, rivalries, clashing egos and violent tantrums. But, to begin with, the egomaniacal energy was creatively transmuted into collective will. In the past few months the accumulated grudges among the top dogs have threatened to become terminally destructive. Anxious for their jobs, lots of ordinary MPs, too, have oscillated between defeatism and mutiny. Mr Field's apology may, perhaps, suggest a just-in-time realisation that bickering and backstabbing are a sure path to oblivion.

Labour could yet go back to self-mutilation if the government sticks to its bizarre plan to increase the time suspected terrorists can be held without charge, and if (or when) the Tories win in Crewe. But the other implicit apology—from Mr Darling to the country—at least lets Labour MPs hope that the government understands the trouble it's in. It was humiliating, but in contrast to the technocratic fiddles with which Mr Brown has hitherto tried to rescue himself, it was bold and big enough to be understood by voters. Even if many of them were plagiarised, some of the ideas in the “draft Queen's Speech” Mr Brown delivered on March 14th—such as helping low-paid savers and making the police more accountable—may also help. (The speech was part of a strange new phenomenon whereby policies seem to get announced earlier and earlier, then revised later and later.)

But for Labour to revive, and maybe for Mr Brown to survive, it will take more than a semblance of unity and the odd crowd-pleaser. It will (among other things) require the prime minister to change: his style, his demeanour, the way he treats his ministers—the very things Mr Field apologised for criticising. In fact, beneath the hostility, and perhaps partly explaining it, the two men are oddly similar. Both are hard-working, religious ascetics who care about the poor. Both are (or were) more respected than liked. Both have been thought of as stubborn and prickly. Mr Field managed to swallow his pride; Mr Brown needs to renounce his altogether. Sometimes, saying sorry is not enough.

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The UN and humanitarian intervention

To protect sovereignty, or to protect lives?

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Illustration by David Simonds

The new notion of global responsibility to alleviate suffering has struggled to win acceptance—and Myanmar will not be the place where it comes of age

“IT WOULD only take half an hour for the French boats and French helicopters to reach the disaster area.” Those were the wistful words uttered by Bernard Kouchner, France's foreign minister, as his country's diplomats at the United Nations vainly argued that aid might have to be “imposed” on Myanmar if the military regime refused to co-operate.

Even as he spoke, diplomats from China, Vietnam, South Africa and Russia were mocking his idea that the “responsibility to protect” (a new concept in global affairs, implying that saving human lives might in some extreme circumstances override sovereignty) could be invoked in the case of Myanmar's cyclone. China noted acidly that the idea had not been cited in 2003 when France suffered a deadly heatwave.

David Miliband, Britain's foreign secretary, reignited the debate on May 13th. Challenged by a radio interviewer to say whether the new concept (designed to deal with crimes like genocide or ethnic cleansing) could also apply to natural disasters, he replied: “It certainly could, and we have been absolutely clear...that all instruments of the UN should be available.” But nobody expects Britain, France or any other country to fight its way into Myanmar. As Mr Miliband observed, “the regime has 400,000 troops in uniform.” For ordinary people, unfamiliar with the UN's arcane workings, it looks rather depressing. Will there ever be a good moment to cite the notion of a responsibility to protect—unanimously adopted by more than 150 states at the UN World Summit in 2005—as Mr Kouchner is now suggesting?

The tortuous development of that concept is a tale close to the French minister's heart. As a young doctor, he saw the horrors of the Biafran famine triggered by Nigeria's civil war. Soon afterwards he co-founded Médecins Sans Frontières (Doctors Without Borders) and became a leading supporter of the “right of humanitarian intervention” in cases where governments fail their own people.

What Mr Kouchner was proposing sounded, in its stronger versions, like a revolution in global affairs—overturning the 1648 treaty of Westphalia, which upheld the right of sovereign states to act freely within their own borders. The UN Charter of 1945 also upholds the Westphalia principles, by stating in article 2 (7), that “nothing should authorise intervention in matters essentially within the domestic jurisdiction of any state.” But Chapter VII does entitle the Security Council to take action in cases of a “threat to the peace, breach of the peace or act of aggression”.

Tension between those two principles—sovereignty versus intervention—has been palpable for decades. Some countries stress the enforcement powers laid down by Chapter VII. Others (mostly in the poor world) insist that state sovereignty always trumps, even in humanitarian emergencies.

In practice, since the end of the cold war the UN has been intervening more often in conflicts within (as opposed to between) states. Sometimes it has happened with, and sometimes without, the consent of the governments concerned.

In 1999 Tony Blair became the first world leader to assert a moral right to “get actively involved in other people's conflicts”—even without leave from the Security Council—if it was the only way to stop dire suffering. Speaking in Chicago after NATO's war over Kosovo, which the Security Council had declined to endorse, Britain's then prime minister made the case for “just war, based not on territorial ambitions, but on values”.

Four years later, an American-led coalition invaded Iraq, using somewhat similar rhetoric about the need to overthrow a dangerous tyrant for the good of everyone. Although it wasn't in any formal or legal sense a test case for responsibility to protect, many people felt that the disastrous outcome in Iraq discredited the entire idea of intervention for “altruistic” purposes.

Less of a right, more of a duty

Meanwhile, Canada had set up an International Commission on Intervention and State Sovereignty, under the chairmanship of Gareth Evans, a former Australian foreign minister, and Mohamed Sahnoun, a former Algerian diplomat. In their report, published in 2001, it was they who first suggested changing the discretionary “right to intervene” into a more muscular “responsibility to protect”, or R2P as it is known in diplomatic jargon. Under it, the “international community” (in effect the UN) would be placed under an actual obligation to take, if necessary, coercive action to protect people at risk of grave harm, in accordance with clear criteria.

Taken up by a High-Level Panel on UN reform in 2004 and adopted by Kofi Annan, then UN secretary-general, the principle survived the haggling in the run-up to the 2005 World Summit to squeeze its way into the final “Outcome Document”, though shorn of criteria. But it was never intended to cope with the aftermath of natural disasters or even “ordinary” human-rights violations. It was to be invoked only for genocide, war crimes, ethnic cleansing or crimes against humanity.

From the start, the idea was viewed by the developing world as a trick by the West to impose its values. Cuba, Egypt, Russia, Algeria and Myanmar have been vocal opponents. They have been leading a determined effort to obstruct the formal appointment of Edward Luck, a professor at Columbia University, as a special UN adviser on the issue. He still has no salary, no real title and no UN office.

Others, this time in the West, are asking whether responsibility to protect will ever be more than an empty slogan. When it came to it, who would be willing to intervene? How could such action ever get past all five of the Security Council's veto-wielding powers? Besides, as a senior UN official laments, the Iraq fiasco has “poisoned this well”. It showed that an armed intervention, even if its declared aims are benign, can set off a whole chain of terrible consequences.

“It never takes much more than a few days around the corridors and meeting rooms of the UN in New York to have your latest dose of optimism beaten out of you,” Mr Evans moaned recently. But he and other proponents of responsibility to protect have started to fight back, seeking to correct “misconceptions” over the concept. It's not meant to be a grand new doctrine or policy, they insist, rather a modest “strategy” for protecting the defenceless.

It is not only about military intervention, they add, but also prevention: spotting situations that could result in mass atrocities. Political, diplomatic, legal and economic measures should be tried before any resort to arms. Not every conflict, potential conflict, or gross abuse of rights should prompt application of the rule—only the worst cases. And even when all non-military means have failed, armed intervention may still not be the right answer. The consequences must be weighed to ensure that it will not do more harm than good to the people it seeks to protect.

Responsibility to protect is not yet dead, but it is fragile. Supporters point to the power-sharing deal that stopped Kenya's civil war in February as the concept's first success. The fact that the UN, in principle, retains the right to impose its will by force may have made it easier for the world body to broker a

settlement.

Perhaps. But the idea will need some clearer successes than that if it is going to survive. And Myanmar, apparently, is not going to be one of them.

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The value of keeping order

A dismal calculus

May 15th 2008
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Yes, peacekeeping makes sense: an accountant's view

Get article background

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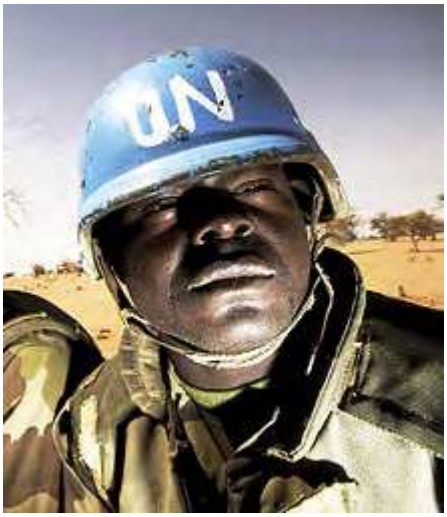

Tell me what I'm worth

EVERY time a conflict in some poor and chaotic place simmers down to the point where peace has a chance, rich countries with an interest in reconstructing that country face a choice: do they merely provide economic aid, or should they also despatch troops—their own or other countries'—to nail down and enforce the peace? A new study offers an economist's answer to that dilemma by putting figures on the cost of war—and on the relative success rates of mainly financial assistance, and of armed peacekeeping, in consolidating peace and getting a country moving.*

To state the obvious, internal conflicts take their toll on growth. The authors reckon that countries affected by civil violence lose, on average, just over two percentage points of growth a year and take 14 years to get back to normal. That works out at an entire year's lost output. Since the violence usually spills over borders, the neighbours suffer too: the cost to them is as great as to the countries concerned.

Taking all this into account, and adding a bit for extra military spending, the direct cost of a conflict in a typical developing country (whatever that is) comes to about $60 billion, the authors say. But most wars also envenom entire regions and exacerbate international scourges such as crime and terrorism.

So the authors give a “speculative” figure for the broader cost of each conflict: $250 billion. Since 1960, there have been two outbreaks of civil war a year, so what might be called the running cost of new conflicts in developing countries works out, on the authors' calculus, at somewhere between $120 billion and $500 billion a year. Even the lower figure is huge: about the same as the total amount of development aid doled out every year.

So even for the most stony-hearted mercantilist, the avoidance of renewed war makes sense. The authors agree that purely financial assistance helps to achieve that aim. They think aid worth two percentage points of a conflict-riven country's GDP over ten years increases growth by one point. That would be good in itself and cut the risk of further conflict. If countries are stagnant, the authors say, conflict breaks out again 42% of the time; if they grow for ten years, the rate of recidivism tumbles to 27%.

But reducing the risk of conflict more directly through peacekeeping is, the authors maintain, even better value for money. If the total cost of war to a country and its neighbours is $60 billion-$250 billion, then each percentage-point reduction in the risk of renewed violence is “worth” $600m-$2.5 billion. The authors calculate that if the world spent $8.5 billion on ten years of peacekeeping in a crisis-ridden country, that would reduce the risk of conflict by 30 points, which would be worth between $18 billion and $75 billion. A worthwhile way of getting a bang (or rather, a non-bang) for your buck.

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* “The security challenge in conflict-prone countries”. By Paul Collier, Lisa Chauvet and Havard Hegre. Published by the Copenhagen Consensus.

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Economist.com WORLD INTERNATIONAL

Climate change

A moment of truth

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Make-or-break for an idea that is meant to help the poor grow and be green

Reuters

It's not just the market that's drying up

FOR the system that is supposed to make it easier for people in the rich world to cut the greenhouse emissions of the poor, a “binary moment” has come. That, at the least, is the prediction of a banker with an interest in the future of the clean development mechanism (CDM). Like many others in the business, he foresees either buoyant growth or terminal decline for the arrangement designed to encourage financial transfers from long-established carbon emitters to emerging ones.

On the face of things, business is booming: trading in the credits that are the CDM's currency more than doubled last year, to $13 billion, the World Bank says. It reckons the CDM has prompted investments of $59 billion. But the same report says the value of new projects under the CDM will barely grow this year, halve next year, and shrink to almost zero by 2010.

The incipient atrophy stems from the looming expiry of the Kyoto protocol, the United Nations' treaty on global warming, at the end of 2012. It requires rich countries (save America, which never ratified it) to cut their emissions of greenhouse gases to an average of 5% below the level of 1990. But to make these cuts easier to achieve, and to begin to involve poor countries in the fight against global warming, the treaty also set up the CDM. It permits governments or firms from rich countries to pay for projects to cut emissions in more benighted places, and to count the resulting credits against domestic targets.

Last year, the UN launched talks on a successor to Kyoto. It hopes a new treaty will be agreed by the end of next year, at a big pow-wow in Copenhagen. But that is far from certain. What is more, a new agreement would not necessarily preserve the CDM in its present form. Many critics call it too slow and cumbersome to reduce emissions on the scale needed. Others say the CDM offers poor value for money, and that the element of development has been forgotten. Meanwhile, the World Bank says there will soon be enough projects under way to meet the expected demand from rich countries under Kyoto. Hence its view that business is about to dry up.

At the moment, there are over 3,000 CDM projects in progress, according to the World Bank. Firms can propose anything that would cut greenhouse emissions, from distributing electric bulbs to substituting clean fuels for dirty ones at power plants. The only restriction is known as “additionality”: to be eligible, a project must only be viable thanks to the extra revenue that selling credits will bring. Project developers must hire an approved auditor to vet their designs before submitting them to the board that oversees the CDM. Auditors must check on the implementation of projects before the developers can again apply to the board for credits, known as “certified emissions reductions”.

Only 300-odd projects have won credits to date, in part because the CDM only really got going after Kyoto took effect in 2005. Over half of them involve reducing emissions of trifluoromethane, a by-product of refrigerant and Teflon production and an especially nasty greenhouse gas. It is cheap to get rid of, so projects that do so have proved enormously profitable.

In fact, Michael Wara of Stanford University calculates that the credits from cleaning up refrigerant production are twice as valuable as the refrigerants themselves. This would have given firms an incentive to produce more trifluoromethane, simply for the sake of cleaning it up, had the UN not amended its

rules to exclude new factories from participating in the CDM. Nonetheless, Mr Wara maintains, the riches on offer from the CDM are discouraging governments in the developing world from taking easy steps to reduce their countries' greenhouse-gas emissions.

He cites China, where partly state-owned power firms are applying for credits for building gas-fired power plants instead of dirtier ones run on coal. He argues that China, which is keen to improve air quality anyway, would probably be building such plants with or without the CDM. But the government might now hesitate to issue regulations to that effect, for fear of violating the “additionality” rule, and so losing out on valuable credits.

Indeed, 60% of the CDM work under way is in China, which has lots of big, grubby factories, ripe for refurbishing. Yvo de Boer, the head of the UN agency that oversees the Kyoto protocol, argues that these provide the biggest and cheapest opportunities to cut emissions, and so have naturally attracted the first CDM investments. But he points out that money is now flowing to other countries and other kinds of projects. Energy-efficiency and fuel-switching, for example, accounted for 40% of the projects started last year, while biomass, wind- and hydro-power made up another 24%. Africa's share is rising fast.

But most of these projects have yet to receive any credits. In part, that is because brokers have turned to them only after more lucrative opportunities have been exhausted. But the increasing exactitude of the CDM's Executive Board is also slowing things up. Until April last year, it accepted 82% of proposals without question, and ultimately approved over 96%. But over the past year, those figures have fallen to 57% and 87%. It is also getting stricter about implementation, questioning 26% of requests for credits to be issued, and rejecting 2%, versus 9% and 1% previously.

The whole process of designing a project, having it reviewed by both auditors and the board, and then repeating the procedure once the design has been implemented takes years, brokers say, and raises costs. Approved auditors are in such short supply that finding one can take six months; and there is no certainty about the result, given the board's new ferocity.

Only doing their job

But the UN's bureaucrats say they are just trying to be thorough and consistent. They argue that vigilance is all the more necessary when business is growing very quickly and many of the auditors and applicants are hazy about the rules. To provide a clearer idea of their expectations, they are publishing a new handbook for auditors. They have also designed new procedures to allow similar projects to be bundled together in a single application, to cut back on paperwork. And they have hugely increased their own numbers, to cope with the growing workload: the staff of the office that supports the board has grown from 12 in 2005 to 82 today.

But bankers and brokers doubt that these measures will suffice. Some say the UN should offer less onerous monitoring for projects that would be willing to accept fewer credits than originally requested. Others want the UN to abandon the concept of additionality, the stumbling block for about half the rejected applications. It is impossible to say with any certainty what would have happened in the absence of the CDM, they argue, so all decisions based on that premise are inevitably subjective. They would prefer that the UN simply set technical standards for qualification, allowing all cement plants of a certain efficiency to qualify, say, or all renewable-energy projects.

Setting benchmarks would be hard, since some poor countries have more advanced factories or a higher penetration of renewable energy than others. One solution, says Kate Hampton of Climate Change Capital, an investment bank, might be to set higher standards for richer developing countries such as China. These could also gradually rise over time, in an effort to prepare the biggest developing countries to participate in a global emissions-trading scheme. But the setting and amending of such standards would involve endless haggling—as if the effort to cool the planet wasn't hard enough.

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Paradise lost

May 15th 2008
From The Economist print edition

Illustration by Simon Pemberton

Banks are bound to fail from time to time. But, asks Andrew Palmer (interviewed here), does the fallout have to be so painful?

WILSON ERVIN, the chief risk officer at Credit Suisse, a large Swiss bank, cannot pinpoint the precise moment he knew something was up: “This was not like Paul on the road to Damascus.” But signs of the gathering subprime storm in America started to trigger alarms in late 2006. Data from the bank's trading desks and from mortgage servicers showed that conditions in the subprime market were worsening, and the bank decided to cut back on its exposures. At the same time Credit Suisse's proprietary risk model, designed to simulate the effect of crises, signalled a problem with the amount of risk-adjusted capital absorbed by its portfolio of leveraged loans. It duly started hedging its exposure to these assets as well.

Mr Ervin could not have guessed at the sheer scale of what was coming. For nine months now, banks have been in a panic: hoarding cash, nervous of weaknesses in their own balance-sheets and even more nervous of their counterparties. More damaging still, money-market funds have steered clear of banks as well. The drying-up of liquidity not only created havoc in the backrooms of the financial system. It also wrecked the front door, thanks to the dramatic collapse of Bear Stearns, an 85-year-old Wall Street investment bank that was bought for a song by JPMorgan Chase in March. The Federal Reserve offered emergency funding to the investment banks for the first time since the 1930s, and there were bank bail-outs in Britain and Germany too.

The economic effects are set to be just as striking. According to a study of previous crises by Carmen Reinhart of the University of Maryland and Ken Rogoff of Harvard, banking blow-outs lop an average of two percentage points off output growth per person. The worst crises reduce growth by five percentage points from their peak, and it takes more than three years for growth to regain pre-crisis levels. With so much at stake if the banks mess up, regulators and politicians are now asking fundamental questions. Should banks be allowed to take on as much debt? Can they be trusted to make their own assessment of the risks they run? Bankers themselves accept the need for change. “We've totally lost our credibility,” says one senior European banker.

To regain trust, banks will not need to be totally bomb-proof. Safe banks are easy enough to create: just push up their capital requirements to 90% of assets, force them to have secured funding for three years or tell them they can invest only in Treasury bonds. But that would severely compromise their ability to provide credit, so a more realistic approach is needed. This special report will ask how banks should be run and regulated so that the next time boom turns to bust the outcome will be less miserable for all concerned.

If the crisis were simply about the creditworthiness of underlying assets, that question would be simpler

to answer. The problem has been as much about confidence as about money. Modern financial systems contain a mass of amplifiers that multiply the impact of both losses and gains, creating huge uncertainty.

Standard & Poor's, one of the big credit-rating agencies, has estimated that financial institutions' total write-downs on subprime-asset-backed securities will reach $285 billion, more than $150 billion of which has already been disclosed. Yet less than half that total comes from projected losses on the underlying mortgages. The rest is down to those amplifiers.

One is the use of derivatives to create exposures to assets without actually having to own them. For example, those infamous collateralised debt obligations (CDOs) contained synthetic exposures to subprime-asset-backed securities worth a whopping $75 billion. The value of loans being written does not set a ceiling on the amount of losses they can generate. The boss of one big investment bank says he would like to see much more certainty around the clearing and settlement of credit-default swaps, a market with an insanely large notional value of $62 trillion: “The number of outstanding claims greatly exceeds the number of bonds. It's very murky at the moment.”

A second amplifier is the application of fair-value accounting, which requires many institutions to mark the value of assets to current market prices. That price can overshoot both on the way up and on the way down, particularly when buyers are thin on the ground and sellers are distressed. When downward price movements can themselves trigger the need to unwind investments, further depressing prices, they soon become self-reinforcing.

A third amplifier is counterparty risk, the effect of one institution getting into trouble on those it deals with. The decision by the Fed to offer emergency liquidity to Bear Stearns and to facilitate its acquisition by JPMorgan Chase had less to do with the size of Bear's balance-sheet than with its central role in markets for credit-default and interest-rate swaps.

Trying to model the impact of counterparty risk is horribly challenging, says Stuart Gulliver, head of HSBC's wholesale-banking arm. First-order effects are easier to think through: a ratings downgrade of a “monoline” bond insurer cuts the value of the insurance policy it has written. But what about the second-order effect, the cost of replacing that same policy with another insurer in a spooked market?

The biggest amplifier of all, though, is excessive leverage. According to Koos Timmermans, the chief risk officer at ING, a big Dutch institution, three types of leverage helped propel the boom and have now accentuated the bust. First, many banks and other financial institutions loaded up on debt in order to increase their returns on equity when asset prices were rising (see chart 1). The leverage ratio at Bear Stearns rose from 26.0 in 2005 (meaning that total assets were 26 times the value of shareholders' equity) to 32.8 in 2007.

Second, financial institutions were exposed to product leverage via complex instruments, such as CDOs, which needed only a slight deterioration in the value of underlying assets for losses to escalate rapidly. And third, they overindulged in liquidity leverage, using structured investment vehicles (SIVs) or relying too much on wholesale markets to exploit the difference between borrowing cheap short-term money and investing in higher-yielding long-term assets. The combined effect was that falls in asset values cut deep into equity and triggered margin calls from lenders. The drying-up of liquidity had an immediate impact because debt was being rolled over so frequently.

That is not to suggest that the credit crunch is solely the responsibility of the banks, or that all of them are to blame. Banks come in all shapes and sizes, large and small, conservative and risk-hungry. Alfredo Sáenz, the chief executive of Santander, a Spanish retail giant, recalls attending a round-table of European bank bosses during the good times at which all the executives were asked about their strategic vision. Most of them talked about securitisation and derivatives, but when it was Mr Sáenz's turn, he touted old-fashioned efficiency. He did not get any questions. “There were 'clever' banks and 'stupid' banks,” he says. “We were considered one of the stupid ones.” No longer.

Beyond the banks, a host of other institutions must take some of the blame for the credit crunch. The credit-rating agencies had rose-tinted expectations about default rates for subprime mortgages. The

monolines took the ill-fated decision to start insuring structured credit. Unregulated entities issued many of the dodgiest mortgages in America.

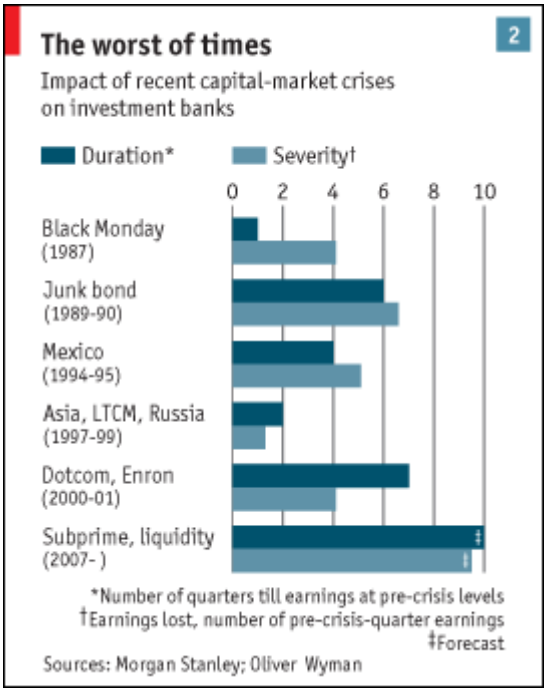
And no explanation of the boom can ignore the wall of money, much of it from Asia and oil-producing countries, that was looking for high returns in a world of low interest rates. “It is indisputable that the global glut of liquidity played a role in the 'reach for yield' phenomenon and that this reach for yield led to strong demand for and supply of complex structured products,” says Gerald Corrigan, a partner at Goldman Sachs and an *éminence grise* of the financial world.

Many blame the central banks: tougher monetary policy would have encouraged investors to steer towards more liquid products. Others blame the investors themselves, many of whom relied on AAA ratings without questioning why they were delivering such high yields.

Wheel-greasers

Still, the banks have been the principal actors in this drama, as victims as well as villains. The S&P 500 financials index has lost more than 20% of its value since August, and many individual institutions have fared far worse. Analysts have been forced to keep ratcheting down their forecasts. “The downside will be longer than anyone expects,” says David Hendler of CreditSights, a research firm. “There is so much leverage to be unwound.”

According to research by Morgan Stanley and Oliver Wyman, investment banks will be more severely affected by this crisis than by any other period of turmoil for at least 20 years. By the end of March the crunch had already wiped out nearly six quarters of the industry's profits, thanks to write-downs and lower revenues. Huw van Steenis of Morgan Stanley reckons that the final toll could be almost two-and-a-half years of lost profits (see chart 2).



Other industries have gone through similarly turbulent times: airlines in the wake of the terrorist attacks on September 11th 2001, technology firms when the dotcom bubble burst. Even within the financial sector the banks are not the only ones currently suffering: hedge funds, insurers, asset managers and private-equity firms have been hit too. But banks are special.

The first reason for that is the inherent fragility of their business model. Bear Stearns, an institution with a long record of surviving crises, was brought to its knees in a matter of days as clients and counterparties withdrew funding. Even the strongest bank cannot survive a severe loss of confidence, because the money it owes can usually be called in more quickly than the money it is owed. HBOS, a big British bank with a healthy funding profile, watched its shares plummet on a single day in March as short-sellers fanned rumours that it was in trouble. It survived, but the confidence trick on which banking depends—persuading depositors and creditors that they can get their money back when they want—was suddenly laid bare.

The second reason why banks are special is that they do lots of business with each other. In most industries the demise of a competitor is welcomed by rival firms. In banking the collapse of one institution sends a ripple of fear through all the others. The sight of customers queuing last September to withdraw their money from Northern Rock, a British bank, sparked fears that other runs would follow.

The third and most important reason is the role that banks play as the wheel-greasers of the economy, allocating and underwriting flows of credit to allow capital to be used as productively as possible. That process has now gone into reverse. Banks have seen their capital bases shrink as write-downs have eaten into equity and off-balance-sheet assets have been reabsorbed. Now they need to restore their capital ratios to health to satisfy regulators and to reassure customers and investors.

For some, that has meant tapping new sources of capital, often sovereign-wealth funds. For most, it has meant reducing the size of their balance-sheets by selling off assets or by cutting back their lending.

Quantifying the impact of this tightening is hard, but one calculation presented by a quartet of economists at America's Monetary Policy Forum in February suggested that if American financial institutions were to end up losing $200 billion, credit to households and companies would contract by a whopping $910 billion. That equates to a drop in real GDP growth of 1.3 percentage points in the following year. If the banks suffer, we all do.

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Ruptured credit

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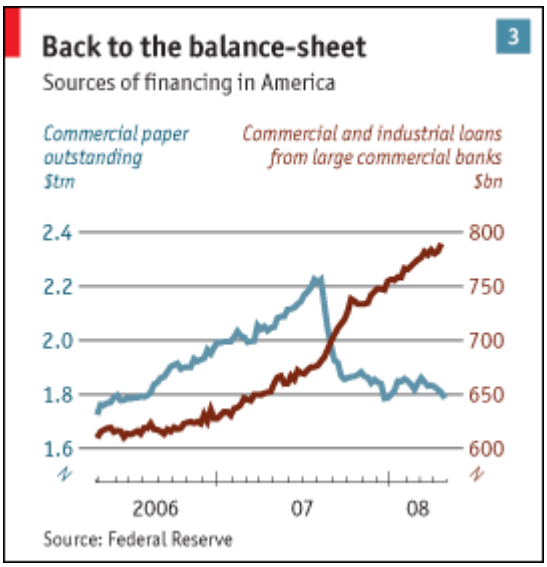
Securitisation has its flaws, but many of them can be mitigated

IT WAS not supposed to be like this. Securitisation, the process of turning the cashflows from a pool of underlying assets (such as mortgages) into bonds, was meant to make the financial system more resilient. Instead of banks holding every loan on their balance-sheet until it reached maturity, risks would be sold on and spread among a wider group of investors.

Now many see securitisation as the villain of the piece. Two charges are levelled against the technique. The first is that it failed to disperse risk effectively; when push came to shove, the risks flowed back to the banks as toxic assets were returned to their balance-sheets. Citigroup and HSBC between them consolidated assets worth $94 billion that had been sitting in structured investment vehicles (SIVs).

Banks that had been acting only as distribution centres for securitised assets were still stuck with billions-worth of them. Less smart ones had taken punts on the securities themselves. There were secondary exposures as well, to borrowers such as hedge funds that had invested in asset-backed securities and whose collateral fell in value.



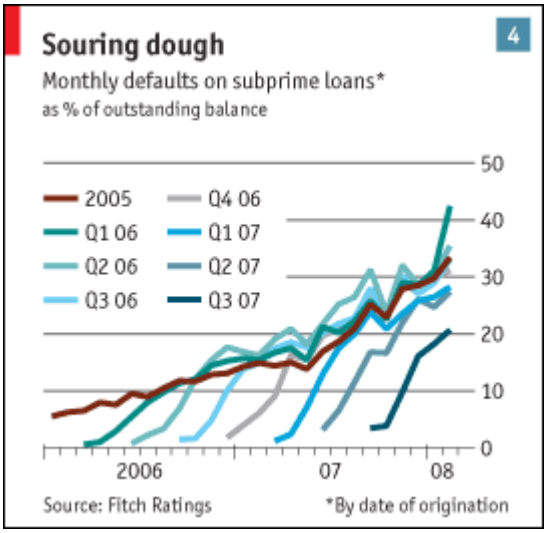
Some argue that the events of the past few months, far from exposing securitisation as a failure, showed that it did not go far enough. If loans had really been sold off to investors, banks would not have been sucked so deeply into the mess. But enforcing a firewall between investors and their bankers is hard. Even where there was no formal commitment to provide liquidity, many banks took assets onto their balance-sheets to protect their reputation with clients (see chart 3).

Would it have helped to have different types of investors? Avinash Persaud of Intelligence Capital, a consultancy, draws a distinction between potential “risk absorbers” such as insurers, pension funds and banks themselves, who are able to take a long-term view of the credit and hang on to it even if the price falls, and “risk traders”, whose views of the credit are driven by the current price. A rush to the doors by risk traders was to blame for the freeze in liquidity across asset classes; had more investors behaved like risk absorbers, things would not have been so bad. But being a risk absorber is more difficult in a world where fair-value accounting requires many long-term investors to recognise falling prices, and where high leverage can force even patient investors to liquidate positions. (It is perhaps telling that the white knights of this crunch, the sovereign-wealth funds and the central banks, do not suffer from either problem.)

The second charge levelled against securitisation is that it degrades credit quality by weakening lenders' incentives to monitor the quality of the loans they write. If loans were even less likely to come back to their originators, this monitoring problem would only get worse.

That securitisation caused more subprime mortgages to be written is not in doubt. By offering access to a much deeper pool of capital, securitisation helped to bring down the cost of mortgages and made home-ownership more affordable for borrowers with poor credit histories. The value of subprime mortgages originated in America shot up from $190 billion in 2001 to $600 billion in 2006. Much of this growth was fuelled by securitisation: the volume of subprime issuance as a percentage of subprime mortgage origination rose from 50% to 80% in the same period.

Bringing down the cost of capital need not mean mispricing risk. The performance of subprime loans securitised up to 2004 has remained relatively solid. But it is a very different story for the later vintages (see chart 4). CreditSights, a research firm, reckons that foreclosure rates of 35% on securities issued in 2005 and beyond are entirely possible.



Works of friction

The deterioration reflected surging capacity and competition. More and more institutions were entering the market, some of them with spectacularly bad timing. Merrill Lynch bought First Franklin, a Californian originator which has since stopped lending, for $1.3 billion in late 2006; Morgan Stanley had snapped up Saxon Capital for just over half that amount earlier in the year. Higher volumes went hand-in-hand with lower standards. A working paper by Giovanni Dell'Ariccia, Deniz Igan and Luc Laeven of the International Monetary Fund finds that increases in the number of loan applications by subprime borrowers were associated with a decline in lending standards. Strikingly, there was no such effect in the prime market, where more applications produced more rejections. Standards weakened most where the risks were highest.

The authors blame what economists call “asymmetric information”. Prime borrowers have long, publicly available credit histories; subprime borrowers do not. That might seem like a good reason to be warier of subprime borrowers, but it did not work that way. “The next person in the queue is seen as just another profitable opportunity, rather than someone who has been rejected by another lender,” says Mr Dell'Ariccia.

Securitisation exacerbated the problem. A series of academic papers has shown that lending standards slipped farthest when loans were securitised. Old-fashioned mortgage lending is like a marriage: both bank and borrower have an incentive to make things work. Securitisation, at least in this market, was more orgiastic, involving lots of participants and more fleeting relationships.

Many mortgage brokers and originators were concentrating on writing as many loans as possible and passing them on to arrangers who would parcel them into securities. The arrangers, for their part, worked hard to sell the securities on to third parties. As the distance between borrower and ultimate bondholder increased, the quality of information tended to degrade and the prospects of predatory behaviour went up. The proliferation of complex instruments, an alphabet soup of CDOs, CDO-squareds and CPDOs, made it even harder to understand the composition and quality of underlying assets.

There were navigational aids to help investors but they often gave false comfort. FICO scores, the most widely used credit score in America, were designed to assess the creditworthiness of individual borrowers, not the quality of pools of mortgages. “'Know your customer' is a staple of banking that has largely been forgotten because of the disaggregation of the supply chain,” says Mark Greene, the chief executive of Fair Isaac, the company behind FICO scores.

Tranching is another such navigational aid. Loans in a securitised pool of mortgages are divided into bands based on their credit risk. The safest, “senior” ones at the top have first claim on the cashflows from the underlying assets; the riskier, “subordinated” ones below are next in line. Buying senior tranches offers protection against losses up to a certain level, which was fine until losses exceeded expectations. Investment-grade credit ratings for the senior tranches suggested they were safe even when the underlying collateral was all subprime.

There were hefty prospectuses to look at, but many investors did not bother. In the frothy days of 2006 and early 2007, the pressure was intense. Deals were being placed within three weeks of being announced, sometimes giving credit committees as little as two days to make a decision, at a time when there were lots of other offerings to review as well. “Some investors did their homework, sending pages and pages of questions in writing,” says the head of securitisation at one bank. “Others just asked for the price.”

If securitisation contributed to the boom and bust, does that spell the end of the originate-to-distribute (OTD) model of banking? Or can the system be improved in a way that retains its attractions to both

investors and issuers?

Banking bigwigs answer the question about the end of the OTD model with a resounding “no”. Securitisation is a long-established financing technique that covers a vast range of asset classes. At the moment the primary market is witnessing a protracted stand-off: issuers do not want to issue until the price makes sense and investors do not want to buy until the price has bottomed out. But there are plenty of reasons to expect a revival.

First, America's subprime-mortgage market was especially vulnerable to the flaws inherent in securitisation. Apart from the information shortfall associated with borrowers who lacked proper credit histories, there was also a particularly lax regulatory environment for originating mortgages in America. Plans are now being drawn up to strengthen oversight of the country's myriad brokers and lenders.

Second, demand for securitised assets remains strong. Pension funds must generate decent returns for their longer-lived members. Oil-producing nations and emerging-market governments are awash with capital. Securitisation offers exposure to long-term assets that would otherwise be out of reach. “There is still a need to invest and there are lots of participants with long-term funds,” says Mr Sáenz of Santander. And Peter Sands, the boss of Standard Chartered, a generally admired emerging-markets bank whose SIV was put into administration earlier this year, insists that “it was not illogical to offer clients a vehicle in which to place surplus liquidity for enhanced yield as part of a range of products.” That remains true.

Third, securitisation still offers benefits to issuers. True, the opportunities for regulatory arbitrage have diminished: the outgoing Basel 1 regime perversely gave banks an incentive to securitise assets into off-balance-sheet vehicles because capital charges on credit lines to those vehicles were lower. But securitisation still offers the chance to transfer some credit risk if, say, a lender has built up a concentrated exposure to mortgage debt in a specific city. And it still offers funding benefits, by widening access to sources of capital and enabling banks to achieve higher ratings on a ringfenced group of assets than if they were borrowing on their own account.

Changes are needed. High on investors' wish-lists is greater transparency. CDOs (securitisations of securitisations, which are instruments based on pools of mortgage-backed securities) and SIVs (which issue shorter-term debt than for most CDOs) caused big problems because they were very opaque and particularly susceptible to correlation and liquidity risk.

Fortunately, life need not be so complicated. Plain-vanilla mortgage-backed securities are less highly engineered and offer many of the same advantages as their more complex cousins. At a time when everyone will be more careful about risk assessment, simpler products impose lower costs of credit analysis on end-users, which in turn makes them less expensive sources of funding. “If investors have to do the due diligence, a bigger discount will be applied to opacity,” says Mike Poulos of Oliver Wyman, a consultancy.

Illustration by Simon Pemberton

Better assessment can go only so far, however. Much of the point of securitisation is to reap the benefits of diversification. What differentiates a residential-mortgage-backed security from a single-name corporate loan is its capacity to survive defaults on a tiny portion of its thousands of constituent loans. For investors to track every loan in a pool of this sort would be impractical. But the cost of diversity is a degree of fuzziness about the quality of each individual credit.

Another way to increase comfort levels is to tie originators, whose decision to lend is the most critical in the securitisation chain, more closely to the fate of the underlying credit. That might entail originators keeping more “skin in the game”, by holding on to a greater proportion of assets or by servicing the mortgages. “The originate-to-distribute model needs the originator to retain involvement in collection, and to keep part of the risk,” says Alessandro Profumo, the chief executive of UniCredit, an Italian bank. Banks that have kept proper tabs on the quality of their securitised credit are also in a better position to buy it back when prices fall: the head of another European bank says he is buying back securities at below-par prices because he knows that the underlying credit is

good.

Cynics point out that plenty of banks did retain exposure but still got the risks wrong; and that originators can simply use credit-default swaps to hedge their exposure. Reputations are much harder to hedge, however. Securities that are directly issued to investors by a single bank arguably present a greater risk to the brand than mortgages that are held on balance-sheets. Where mortgages are being pooled from several originators, greater clarity about lenders' identities and the proportion of assets they have contributed to the pool would help forge a more explicit link between originator and asset.

Strings can also be attached in the form of guarantees. For instance, covered bonds, a form of on-balance-sheet securitisation that gives investors recourse to the issuer's balance-sheet as well as to the assets underlying the bond, are expected to benefit from the events of recent months.

Oddly, in the long term much of this is rather good news for banks—or at least for retail and universal institutions. As the quality of credit analysis becomes more important, strong brands built on lending expertise should end up winning more business, whether as originators or arrangers. A paper on America's mortgage market by Atif Mian and Amir Sufi of the University of Chicago's Graduate School of Business showed that securitisation led to higher rates of default on mortgages when loans were sold by originators to unaffiliated, non-commercial bank institutions.

The industry is already rejigging with this in mind. Bank of America shut down its wholesale lending unit at the end of 2007 to concentrate on lending through its own branches. Citigroup's consumer division did a better underwriting job than its investment-banking arm: hence its announcement in January that it was combining its consumer and capital-markets mortgage units into a single business.

Bank to the future

It is already clear that to bring it back to health, the securitisation market needs more transparency and more responsibility. That will make it less attractive than it was as a method of cutting credit risk and obtaining cheap funding. Capacity will drop as lenders hold more of the risk. Margins will fall as investors demand higher yields. But a more sober version of the originate-to-distribute model will emerge.

The failures highlighted by this crisis run deeper than the weaknesses of securitisation, however. Just look at the concurrent relaxation in lending standards in the leveraged-loan market, where underwriters had a lot more information available to them than in the subprime market.

“There's a tendency to look at what's new when these things happen,” says Bill White of the Bank for International Settlements. “That is much more comforting for bankers than saying ‘this was a standard credit bubble and we failed to see all the associated risks’.” Securitisation may have given this boom and bust its own distinctive flavour, but the core ingredients are drearily familiar: over-eager lending, careless investing and a widespread failure of risk management.

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Professionally gloomy

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From The Economist print edition

Illustration by Simon Pemberton

Risk managers take a hard look at themselves

A SENIOR risk manager at one of the world's biggest banks says his moment of truth came when he was looking at HSBC's numbers for the third quarter of 2006: “I remember saying to my assistant: 'This is strange. Have a look at this'.”

What he had spotted was a sharp increase in loss provisions at HSBC's American unit, prompted in part by higher delinquencies on mortgage loans. He dug deeper and found that HSBC's problems were concentrated in the subprime market and portended much worse to come.

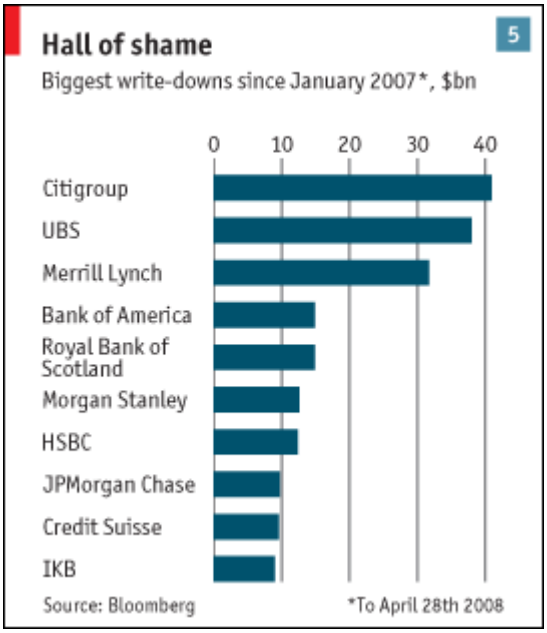
Others were coming to similar conclusions. The smarter banks started to steer away from the problem in late 2006 and early 2007. The rest kept ploughing ahead. Merrill Lynch and Citigroup, numbers one and two in the CDO league tables in 2006, were well on course to beat their year-end issuance records when the markets seized up in August.

More issuance did not just mean higher levels of inventory in the warehouse when the securitisation conveyor belt stopped moving. The worst-hit banks had also used their own money to invest in mortgage-backed securities, primarily those deceptively safe “super-senior” tranches of CDOs. UBS (or Used to Be Smart, as the joke now has it) has written down an astonishing $38 billion in the past nine months (see chart 5).

Investment banks are not the only ones to have messed up, though risk managers from some retail institutions are scathing about them. “Investment bankers who talk about 'exploding short-term gamma risk' earn $2m; someone in our debt-recovery team earns $50,000,” spits one retail banker. “The only difference between them is that the person who earns $50,000 knows what he is doing.” In fact, bad decision-making did not respect sectoral boundaries: witness Northern Rock's fatal reliance on the wholesale funding markets or the decision by sleepy German Landesbanks to enter the world of SIVs.

Whatever the type of institution, it is clear that the quality of risk management can make a very big difference to its performance. Executive-search consultants report that in a market where most banks are drawing up lists of people to sack, risk managers are in heavy demand. Yet those risk

managers are also aware that they are having to base their decisions on imperfect information. The crisis has underlined not just their importance but also their weaknesses.



Take value-at-risk (VAR), a measure of market risk developed by JPMorgan in the 1980s, which puts a number on the maximum amount of money a bank can expect to lose. VAR is a staple of the risk-management toolkit and is embedded in the new Basel 2 regime on capital adequacy. The trouble is that it is well-nigh useless at predicting catastrophe.

VAR typically estimates how bad things could get using data from the preceding three or four years, so it gets more sanguine the longer things go smoothly. Yet common sense suggests that the risk of a blow-up will increase, not diminish, the farther away one gets from the last one. In other words, VAR is programmed to instil complacency. Moreover, it acts as yet another amplifier when trouble does hit. Episodes of volatility send VAR spiking upwards, which triggers moves to sell, creating further volatility.

The second problem is that VAR captures how bad things can get 99% of the time, but the real trouble is caused by the outlying 1%, the “long tail” of risk. “Risk management is about the stuff you don't know that you don't know,” says Till Guldimann, one of the original architects of VAR. “VAR leads to the illusion that you can quantify all risks and therefore regulate them.” The degree of dislocation in the CDO market has shown how hard it is to quantify risk on these products.

Models still have their place: optimists expect them to be greatly improved now that a big crisis has helpfully provided loads of new data on stressed markets. Even so, there is now likely to be more emphasis on non-statistical ways of thinking about risk. That means being more rigorous about imagining what could go wrong and thinking through the effects. House prices in America may not have declined nationally since the 1930s, for example, but the better risk managers still developed models that assumed a drop.

However, stress-testing has imperfections of its own. For example, it can lead to lots of pointless discussions about the plausibility of particular scenarios. Miles Kennedy of PricewaterhouseCoopers, a consultancy, thinks it is better to start from a given loss ($1 billion, say) and then work backwards to think about what events might lead to that kind of hit.

Nor is stress-testing fail-safe. The unexpected, by definition, cannot be anticipated: until last summer, for instance, banks would have said that in the event of a liquidity crisis they could raise emergency funding through securitisation. Doom-mongering can also be overdone: if a bank were to make provision for every conceivable extreme event, it would never write any business. But a qualitative approach is an essential complement to a quantitative one.

Another big challenge for risk managers lies in the treatment of innovative products. New products do not just lack the historic data that feed models. They often also sit outside banks' central risk-management machinery, being run by people on individual spreadsheets until demand for them is proven. That makes it impossible to get an accurate picture of aggregate risk, even if individual risks are being managed well. “We have all the leaves on the tree but not the tree,” is the mournful summary of one risk manager. One solution is to keep new lines of business below certain trading limits until they are fully integrated into the risk system.

Keeping risks to a size that does not inflict intolerable damage if things go awry is another fundamental (some might say banal) lesson. Credit Suisse has a capital-allocation risk management committee whose job it is to strike a balance between the business opportunity and the downside risk. “Risk should be sized to the return and earnings profile of the division,” says John Thain, the boss of Merrill Lynch. “It is not acceptable [for a division] to have a position that wipes out its own earnings, let alone those of the entire firm.”

Grave new world

However, working out the size of the risks is less easy than it used to be. For one thing, the lines between different types of risk have become hopelessly blurred. Risk-management teams at banks have traditionally been divided into watertight compartments, with some people worrying about credit risk (the chances of default on loans, say), others about market risk (such as sudden price movements) and yet others about operational risks such as IT failures or rogue traders.

The crisis has rung the death-knell for that approach. Loans that investment banks assumed were going to be sold on and treated as market risks became stuck on their books and turned into credit risks. Banks lost money on the same mortgage-backed securities in two different ways as prices went down in the trading book and defaults went up in the banking book. “You need to have ways of cutting across the two books and having aggregate limits scaled across both,” says Mr Ervin at Credit Suisse, which has a group that looks at market risk and credit risk together.

The chief risk officer of a large European bank gives another hypothetical example of how entangled things can get. Take a credit desk that wants to make a $500m loan to Gazprom, a Russian gas firm, but has an approved lending limit of only $400m. To make the loan, the credit desk buys a $100m credit-default swap from a trader within the same bank which will pay out if Gazprom defaults. The trader then hedges himself against the risk of paying out on Gazprom by buying protection on a Russian oil firm, assuming that its paths are aligned with those of Gazprom. The end-result is that a simple loan to Gazprom has turned into a far more complex mixture of market and credit risk.

A second source of additional uncertainty is the advent of fair-value accounting, which requires banks to mark the value of their traded assets to market prices (see article). That is fine when markets are highly liquid, but in their search for yield the banks had been actively seeking out less liquid assets. When markets dry up, price discovery becomes difficult. Institutions are forced to use proxies such as indices to determine a price, which may not accurately reflect the composition of their own assets or which may become oversold. When such proxies are unavailable, the valuation process becomes a matter of judgment (or worse, of manipulation: an embarrassing restatement of earnings by the hitherto solid Credit Suisse in March was due partially to intentional mismarking by a few traders).

Counterparty risk adds further confusion. Many derivatives are sold in bilateral “over-the-counter” agreements rather than being traded on exchanges, and suffer from delays in clearing and settlement. “I'd be surprised to come across a global bank that could aggregate its exposure to a counterparty on a single screen,” says Andreas Andreades, the boss of Temenos, a company that provides software for banks. Keeping track of the scale of exposures is even more difficult at a time of deleveraging, when the chains linking different institutions suddenly tighten: a margin call by one bank forces the closure of a hedge fund that weakens a prime broker who has written a credit-default swap on the mortgage-backed securities that you hold.

Derivative contracts are by no means the only source of infection. Mr Timmermans of ING recalls trying to work out his exposure to Bear Stearns when it was wobbling. ING did not have Bear as a counterparty on credit-default swaps, but apart from its direct lending relationship it also had exposure to the Wall Street bank via repo agreements and potential moral obligations to investors in its money-market funds that had invested in Bear. His unsettling conclusion: ING's indirect exposures were of the same order of magnitude as its direct ones. After the collapse of Long-Term Capital Management in 1998, banks started scanning the counterparty horizon more carefully for risks from hedge funds. From now on they will look much more closely at each other.

Another area of concern is basis risk, the risk that a hedging strategy will not be precisely correlated with the underlying investment. Shorting the ABX index, a benchmark for subprime mortgage-backed securities, has been a popular hedging strategy, but the value of an index cannot be a perfect match for the value of highly engineered structured credit. Many institutions are still reporting net rather than gross exposure, and confidence in the safety of hedges has sagged.

Misjudgments are particularly dangerous in a world where leverage has reduced the margin for error and where the gross, or notional, amounts of money at stake are so large. Just prior to going under, Bear Stearns revealed that the notional value of its swap agreements was a staggering $11 trillion. Morgan Stanley blotted an otherwise clean copybook with a trading strategy that went wrong: the bank made the sensible decision to short the subordinated tranches of subprime mortgage-backed securities but the much less sensible one also to buy those wretched super-senior tranches in order to fund the cost of the short position. The bank says that the super-senior positions were stress-tested at well above historic levels, but losses on the trade still accounted for the bulk of its $7.8 billion subprime-related write-downs in the fourth quarter of 2007.

The tale of Société Générale offers another variation on this theme. It says something for the scale of this crisis that the biggest rogue-trading scandal in history has been a mere *divertissement*, but the €4.9 billion ($7.2 billion) losses sustained by the French bank are still part of the main story. Jérôme Kerviel, the man accused of causing the losses, was able to escape undetected for so long because managers kept an eye only on his net positions. As a result, the huge €50 billion notional position on the futures markets he had allegedly built up by faking offsetting trades went unnoticed. In future risk managers everywhere will concentrate much more on the size of banks' absolute exposures.

Such changes will help. But improving the way that risk managers work will not tackle some of the bigger problems. One is that the quality of risk management at individual institutions does not necessarily provide enough information about the overall stability of the system: the sum of the parts is less than the whole. Individual institutions tend to assume that their level of risk reflects a static environment: that positions can quickly be closed out, for example; that closing large positions does not itself move market prices; and that the cost of hedging remains stable.

In practice, none of those assumptions has proved correct; quite the reverse. Given the prevalence of excessive leverage, procyclical risk models and illiquid assets, the effect of lots of different institutions trying to reduce their own risk was in fact to increase systemic risk.

Another problem was that variations in the quality of risk management among different institutions became clear only when disaster struck. Senior executives privately admit that it is extremely difficult for shareholders to see inside institutions and work out just how well they manage their risks. Regulators also confess to difficulties, particularly when it comes to unscrambling the most complex models.

There is an even bigger concern. Everyone is ready to listen to risk managers now, but the message is harder to transmit when the going is good. “Come the next boom we will have traders saying, 'that was eight months ago. Why are you dragging me down with all that?',” sighs one risk chief. To improve risk management through the cycle, deeper change is needed.

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Black mark

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An accounting standard comes under the microscope

THIS has been a crisis of firsts. The first major crisis of the securitisation era; the first big test of the European Central Bank; and the first crisis of "fair-value" accounting, the set of standards which requires institutions to mark many of their assets to market value. Many blame fair value for causing the credit crunch, arguing that it can cause a downward spiral in prices by encouraging institutions to sell assets quickly and forcing them to take write-downs that do not reflect the "true" value of the underlying assets.

"Fair value is a big mistake," says the boss of one big European bank. AIG, an American insurer, has proposed a change to the rulebook so that companies and their auditors would put only their own estimates of maximum losses into the profit-and-loss account.

A lot of the criticism is pure cant. After all, mark-to-market gains were happily accepted by banks before the bubble burst. The regime's more helpful rules are still being applied with gusto: for example, banks are able to reduce the fair value of their own debt issues if the credit spreads on them widen. Barclays, for one, recorded gains of £658m ($1.3 billion) on its own liabilities in fiscal 2007.

The fact that deciding on a fair value has been so tough reflects the complexity of the products as much as the state of the markets. Setting a price for derivatives that have been repeatedly repackaged, overcollateralised and subordinated is difficult in any conditions. "Four thousand pieces of a Porsche are more difficult to value than a Porsche itself and the sum of the parts does not equal the whole," says Bill Michael of KPMG, an accountancy firm (choosing an appropriate car).

Some banks clearly also underestimated the risks of illiquidity. Industry insiders report that prudent institutions were running internal valuation models even when market prices were clearly observable: those that were not had to scramble to develop such models when markets seized up, causing delays in proper disclosure. Many banks failed to price the chances of illiquidity into the cost of internal funding for traders. And some institutions, bankers allege, were parking illiquid structured products in their trading books to attract a lower capital charge (regulators now plan to beef these charges up). That meant mark-to-market losses immediately showed up in their income statements.

The alternative to fair value—holding assets at historic cost—has few admirers. "Is it really better to keep losses and not to tell shareholders?" asks John Smith of the International Accounting Standards Board (IASB). It is striking that executives at American investment banks, which have long been subject to fair-value rules, largely accept the regime.

There are lessons to be learned. With marking to market, a wobble can quickly become a collapse, illiquidity makes prices harder to set and valuations are more susceptible to sentiment. That increased volatility needs to feature in executives' and risk managers' calculations.

Regulators also need to bear in mind that one of the central assumptions of the fair-value regime has not worked out quite as planned. If prices fall too far, as critics say they now have done, investors should be stepping in to buy the assets. But that is difficult when everyone is reducing their leverage. "Clients invariably say they would like to buy but they cannot because they own too much of it already or they own something else," says Colm Kelleher, Morgan Stanley's chief financial officer.

Moreover, fair-value accounting appears to play a part in the upswing of a cycle as well as in the downswing. Research by Tobias Adrian of the Federal Reserve Bank of New York and Hyun Song Shin of Princeton University indicates that banks take on more debt when the mark-to-market value of their assets increases. In other words, fair value did not just worsen the bust: it also fuelled the boom.

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Make them pay

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Bankers' pay is an easy target. Is it the right one?

Illustration by Simon Pemberton

AS GUESTS filed into dinner at this year's *International Financing Review* award ceremony in London, an annual shindig for bankers, one table remained empty. “That's IKB's table,” commented one wag, referring to an ill-starred German bank. But the biggest laugh of the evening came later, when the compere said he had heard that the audience had lost a lot of money recently: “The good news is that it was other people's.”

That punchline neatly sums up the critique now being made of how bankers (more specifically, bosses and traders at investment banks) are paid. When times are good, they enjoy massive rewards. A survey published by America's Bureau of Labour Statistics in 2007 showed that average weekly pay in investment banking was nearly ten times the national figure.

But those rewards are not properly aligned with the risks that are being taken. When these risks materialise, the worst that happens is that bankers lose their jobs. The system of compensation gives them an incentive to take excessive risks because the short-term upside is far greater than the long-term downside. Concern has been expressed both outside and inside the industry.

Most of the proposals for changing the compensation system centre on the composition and timing of bonuses. One idea is to pay a greater proportion of compensation in shares. That gives employees an interest in the health of the overall operation as opposed to just their own individual performance. Another suggestion is to stagger bonus payments over a period of years, providing employees with an incentive to think about the institution's long-term performance.

In theory, both ideas make sense. Bear Stearns's employees, who owned about one-third of the company's shares, have certainly shared in the pain of their company's collapse. But the Bear example contains warnings too. One is that share-based compensation embeds another asymmetry: the decisions that really count are made at the top of the organisation but the outcomes affect everyone. “The problem is that people don't want to be subject to the idiosyncratic performance of a different part of the bank over which they have no control,” says Mitch Petrick, Morgan Stanley's head of sales and trading.

Another caveat is that even significant levels of share ownership do not guarantee an institution's long-term health. Share-based compensation is already common throughout the industry, particularly among senior executives, but it contains hazards of its own. Some are specific to the financial industry: smart traders may hedge their own shares. Others will be familiar to students of executive pay everywhere. Share prices are not fully risk-adjusted, for example: Stan O'Neal walked away from Merrill Lynch with a pay-off of more than $160m, in part because rises in the share price during his tenure had failed to price in the risks inherent in his strategy.

One way to let such risks become apparent is to extend vesting periods. At present a typical vesting period is three years, with shares being paid out either in instalments or in one lump at the end (a practice known as “cliff vesting”).

Some banks pursue a more targeted approach. Credit Suisse sets aside a proportion of its annual bonus pool in a reserve account. If a trader (or a specific desk) also does well the following year, the reserved amount is added to that year's bonus. If not, that amount is clawed back. Mr Ervin, the bank's chief risk officer, says anecdotal evidence suggests that it makes employees think more about the long term.

Claw-claw or more-more?

Any deferral period can still involve arbitrary decisions about time frames, however: what happens if the positions taken by a trading desk look good after one year, bad after three and terrific after five? And any approach that adjusts for risk after the fact, when the damage has already been done, suffers from inherent inefficiencies. Better, surely, to price in risk when the decision to allocate capital is being made?

Determining the cost of funding is not easy, particularly for structured products where risks of illiquidity are higher. “If we could do it *ex ante*, that would be great but risk is rarely understood until after the fact,” says Raghuram Rajan of the Chicago Graduate School of Business. Even so, there is clearly room for improvement.

If you have a bright idea and want to build a gadget, you would expect to pay for raw materials, for use of factory space and so on, says Nader Farahati of Oliver Wyman. Banks stand accused of systematically failing to extract the correct rents from the relevant employees for access to their balance-sheet and to their franchise. Mr Farahati reckons that if all costs were fully loaded, compensation at investment banks would be at least 10% lower.

Marcel Rohner, the chief executive of UBS, has pointed to unduly low funding costs for traders at the Swiss bank's investment-banking arm as a major cause of its woes. Industry-watchers say UBS was not alone. Illiquid assets such as CDOs would often be funded internally at a low overnight rate that assumed the position could be closed out in a day, for example. This mismatch may have increased the margin on the investment but did not reflect the bank's real risks.

Charging a more appropriate internal funding rate, and assuming bigger haircuts (reductions in value) on assets held as collateral, would have returned more money to the bank's treasury department and ensured that a trader's eventual bonus reflected the risks taken more accurately. It would also have shown upfront that the risk-reward ratios on some products simply did not make sense. Reviews into internal funding policies are now under way at many banks. “Liquidity has to have a price,” says Peter Neu of the Boston Consulting Group.

All for one

However, making dramatic changes to compensation structures involves a prisoner's dilemma. Although it might benefit everyone in the industry to tighten up on bonuses, there is a market at work here: better pay attracts better people. Even Warren Buffett, the world's most revered investor, could not stop an outflow of people from Salomon Brothers in the 1990s when he backed plans to cut bonuses.

The pressures on institutions to keep their rainmakers were starkly demonstrated again during this crisis. Hobbled by huge write-downs, UBS raised the proportion of shares in its 2007 bonuses but softened the blow by reducing vesting periods to just one year from the normal three. Merrill Lynch allowed its compensation-to-income ratio to balloon in 2007 rather than risk an exodus (see chart 6). And when JPMorgan Chase took over Bear, it quickly offered Bear's star brokers generous bonuses to prevent other firms from poaching them.

Even if the banks stood firm on bonuses, alternative employers such as private-equity firms and hedge funds might offer more to snap up disenchanted workers. Any reform in this most sensitive of areas will be gradual.

Besides, it is not at all clear that compensation is the right suspect to be held responsible for the credit crunch. Bankers were not always this well-paid, after all, but financial crises still occurred. And losing one's job is a pretty big sanction. Wall Street banks have already cut their payrolls savagely in response to the turmoil. Celent, a research firm, reckons that over the next 12-18 months American commercial banks will shed 200,000 jobs, or 10% of their workforce. “Moral hazard is not an issue,” says one leading European banker. The price of messing up is that “I lose my job. That's far more

of an incentive to perform than abstract things like being too big to fail."

Although people do find other jobs, these are usually less senior than before, so career paths suffer. Those who worked in structured credit will find it particularly hard to get jobs at the same level. Recruiters are also unanimous that money is not as important as outsiders assume: many in the industry are far more motivated by the desire to outshine their peers than to buy yet another weekend retreat.

Since pay structures during the boom looked rather similar across Wall Street, and senior executives all have sizeable shareholdings in the banks they run, compensation also does little to explain the differences between those institutions that have done well during the crisis and those that have not. For that, you have to look at the quality of management.

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Tightrope artists

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Managers of banks face a tricky balancing-act

WHEN leading bankers talk of par and downswings, you might think they were referring to the markets. But to judge by the revelations from Wall Street over the past few months, they may just be discussing their golf games. Stan O'Neal, ousted as head of Merrill Lynch last October, and Jimmy Cayne, the erstwhile boss of Bear Stearns, both escaped to the links when the credit crunch bit in the summer of 2007. (The versatile Mr Cayne also made lots of time for his love of bridge: he was playing in a tournament in Detroit on the weekend when JPMorgan Chase negotiated its takeover of Bear Stearns.)

Having hobbies is one thing, keeping your eye on the wrong kind of ball quite another. The institutions that have done (relatively) well during this crisis have been run by management teams that are strongly engaged. People who have worked with Jamie Dimon, the boss of JPMorgan Chase, talk admiringly of his familiarity with specific loan portfolios. Dick Fuld of Lehman Brothers attracts similar praise. “He rocks the boat daily,” says one industry veteran.

“Hands-on bosses tend to have done better,” reflects John Thain, Mr O'Neal's successor at Merrill Lynch. Since coming on board, Mr Thain has changed the reporting lines at Merrill so that the head of risk management answers directly to him rather than to the heads of the business units. He has also instituted weekly risk-committee meetings to review the firm's exposures.

Baudouin Prot, the chief executive of BNP Paribas, a large French bank, echoes the sentiment, whipping out a piece of card from his wallet to prove his point. The card has the names and numbers of the 95 people who hold the most important positions at the bank. Mr Prot says he has worked with most of them for many years.

It also helps for bosses to have the right kind of experience. Lloyd Blankfein, the chief executive of Goldman Sachs, is a trader by background. When the crisis struck, Goldman had at least ten people in its senior management ranks who had been in charge of its mortgage business.

Others were less prepared. Mr O'Neal oversaw a massive push into structured credit but lacked a trading background. Chuck Prince, the former head of Citigroup, was thought by many to be doing a decent job of cutting through the bank's bureaucratic thickets, but he came to the top job via the role of general counsel. The appointment in April of Peter Kurer, another lawyer, as chairman of UBS has also attracted criticism. Old Wall Street hands say that getting to the top too often relies on attending lots of committees. “The top guy should be the best at his job, not the guy spending all of his time in internal meetings,” says Ken Moelis, the former head of UBS's investment bank and now the boss of his own advisory firm.

The overall culture of the organisation matters as much as the experience of its top brass, particularly when it comes to risk management. At Goldman Sachs, for example, people are routinely rotated between control functions and business functions so that each has an equal cachet, and problems are discussed by a broad range of insiders. Other firms are more compartmentalised. “In the past risk-management meetings were not a dialogue,” says a senior executive at another bulge-bracket firm. The best firms are also less tolerant of breaches in process. “The number of firms that will investigate an unusual profit is smaller than the number of firms that will investigate an unusual loss,” says Andrew Gray of PricewaterhouseCoopers.

In some of the more successful retail banks, risk management is similarly ingrained into the culture. Santander's risk managers are grilled by the firm's executive committee every Monday, with their independence safeguarded by a reporting line to a vice-chairman. Santander has even managed to make golf a parable of risk management. The golf course that runs behind the bank's impressive campus just outside Madrid is said to have been designed so that there are two ways of playing each hole—a riskier, direct line or a safer approach that requires two shots.

The trouble with banks

If the way that banks are run and managed is so important to how they weather a crisis, that begs a question: are banks particularly susceptible to failures of governance?

The short answer is yes, partly because of what banks do. “They are opaque and their business is to take risk,” says Stijn Claessens of the International Monetary Fund. “That makes them harder for shareholders to govern.” Investment banks are particularly hard to fathom because of the complexity of their business and the volatility of their earnings. This opacity shows up in their price-earnings ratios, which made little distinction between the different Wall Street banks before disaster struck (see chart 7).

The culture of banks is a contributory factor, with investment banks again particularly culpable. Levels of turnover at most investment banks are high, which weakens the institutional memory of previous crises. Levels of product innovation are also high, which means that many products have not come under stress. Few bank employees would have had experience of both the full business cycle and of CDOs, for example.

Many banks also seem to be poor at nurturing talented managers. The search for successors to Mr Prince and Mr O'Neal showed up a striking absence of suitable successors at either Citigroup or Merrill Lynch. At one point it felt as if Mr Thain was the only person on the planet capable of running a large bank.

Again, high levels of staff turnover may be partly responsible. Weeding out the poorest traders now could also mean getting rid of the best future managers. Headhunters say it is very unusual for people to be both great traders and great managers. Back-stabbing and internal politics help to thin the ranks of talented senior people too. High pay in the lower ranks of the bank may in any case weaken the incentive to slog up the management ladder. “At many firms there is a very small number of well-rounded managers and then legions of 'transactors' below,” says Cindy Levy of McKinsey, a consultancy.

Still, some firms do better than others. Goldman Sachs has made more effort than most to develop its people's management skills: its first “chief learning officer”, Steven Kerr, joined the bank from General Electric, where he ran the industrial conglomerate's famed Crotonville training facility. According to Lucia Ferreira of Russell Reynolds, a firm of headhunters, banks were already starting to pay more attention to management skills before the crisis struck. That trend will accelerate. When Vikram Pandit became chief executive of Citigroup, one of the first appointments he made was to the newly created post of chief talent officer.

Goldman Sachs also has a more collective approach to management than many others. “The partnership culture does go a considerable distance in helping to appreciate how this place works,” says Gerald Corrigan. Whatever the secret, others have found it hard to replicate. One industry consultant says that attempts by other firms to copy Goldman's approach of taking a “management” position, a trading stance based on the major exposures generated by the bank's own traders, have foundered on opposition from the heads of these firms' business units.

Part of Goldman's success is self-reinforcing: partnership cultures depend on low turnover, and employees are less likely to leave a successful firm. Goldman may also have been helped by being one of the last Wall Street firms to go public, in 1999: the vestiges of partnership have had less time to erode. And smaller organisations find it easier to maintain a sense of collective ownership. Although Goldman has grown rapidly in recent years, as have other investment banks, it still employs a relatively modest number of people.

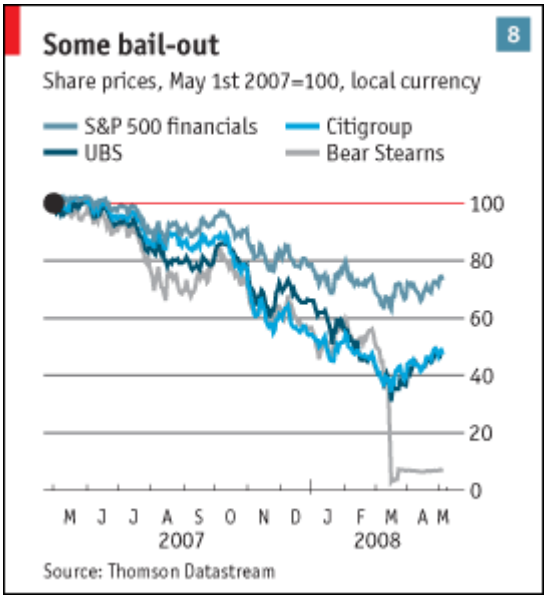
The inverse relationship between size and success does not always hold true: Bear Stearns was the smallest of the Wall Street brokers, whereas JPMorgan Chase, though a titan, has come through the crisis well to date. But compare the size of a Goldman (some 30,000 employees) with a monster such as Citigroup, which has ten times as many workers and operates in many more product areas, and it is pretty clear which is likely to be harder to run. Moreover, Citigroup grew to its current size by a series of

acquisitions—in particular, the $140 billion merger of Citicorp and Travelers in 1998.

Owner or enemy?

Will the recent shambles encourage change? Shareholders have certainly been given a big incentive to monitor risk-taking and compensation structures more carefully (see chart 8). Moral hazard or no, shareholders in Bear Stearns have seen a drop of more than 90% in the value of their holdings over the past 12 months. The owners of Citigroup and UBS are down by about 50% over the same period. Shareholders in Britain's Northern Rock, which was nationalised in February, are furiously challenging the basis on which the government is valuing the bank's shares. If these are bail-outs, they are certainly not painless.

There are already signs that shareholders are taking a much closer interest in the way banks are run. Even before credit crunched, HSBC was facing an assault on its strategy and pay policies from Knight Vinke (though the activist fund's criticisms look less apposite now). Other banks are now feeling the heat too. UBS is under pressure from a number of activists, among them a fund run by Luqman Arnold, a former boss of the bank, to spin off its investment-banking unit. Restlessness among shareholders helped to oust Marcel Ospel as UBS's chairman in April.



Dominique Biedermann, the executive director of Ethos, an activist fund, says the 2006 results gave UBS shareholders no inkling of trouble ahead: “We thought we were investors in a normal, classical bank; it turns out we were shareholders in another kind of bank that takes a lot of risk.” The normal sanction of the unhappy owner—dumping the shares—is not an option for Ethos because of the size of UBS (and Credit Suisse) in relation to the Swiss stock exchange.

In America, too, shareholders are gradually waking up. Bank executives have faced much greater scrutiny during this year's round of annual meetings. Resolutions to give shareholders a non-binding vote on managers' pay have garnered decent levels of support. A number of advisory firms have recommended that shareholders vote against the management of Morgan Stanley, Citigroup, Washington Mutual and others on the re-election of specific board directors.

Not every precept of good governance makes sense for businesses as special as banks. The desirability of having a slew of truly independent non-executive directors has to be set against the value of having people who truly understand the business, for instance. But more careful scrutiny of the composition of banks' boards, as well as more transparent pay schemes, would be good causes on which to use shareholder muscle.

Pessimists put forward two arguments. The first is that the wave of money that has come into the sector in the past 12 months from sovereign-wealth funds and other state-backed investors—some $85 billion at the last count—is unlikely to encourage a robust shareholder culture. Such funds are programmed not to kick up a fuss.

The second argument for pessimism is that the stability of the system is not always the shareholders' first concern: when times are good, they may positively encourage excessive risk-taking. Cast your mind back to those halcyon days before the crash, for example, when instead of pressurising banks to beef up their risk-management systems, shareholders were asking them to return more money through buy-back programmes. Citigroup repurchased $12.8 billion-worth of shares in 2005 and $7 billion-worth in 2006, keeping its capital ratios flat at a time when raising its buffers would have been a better strategy. Many banks, particularly European ones, have steadfastly kept up their dividend payments throughout the crisis, despite pleas from regulators to cut dividends and concentrate on rebuilding capital levels. Recent research by Luc Laeven of the IMF and Ross Levine of Brown University suggests that banks may actually run higher risks in order to compensate for the effects of tougher capital requirements, so long as they have an owner with sufficient clout to exercise control.

This is the context in which to judge Mr Prince's notorious remark last July that as long as the music was

playing his bank would still be dancing. His timing was spectacularly bad but his thinking was essentially correct: executives who say no to growth will not win favour with shareholders, even when everyone knows the system is heading for trouble. Claudio Borio of the Bank for International Settlements sums it up: “We wouldn't need regulators if the private sector could take care of things by itself.”

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Cycle clips

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From The Economist print edition

Illustration by Simon Pemberton

Regulators need to counterbalance the cycle, not accentuate it

“OUR industry is prone to excess,” says one of Europe's most senior bankers. You can say that again. As the crisis unfolded, the search for historical parallels got under way: the blow-up of Long-Term Capital Management in 1998, the bursting of the leveraged buy-out bubble in the early 1990s, the Nordic banking crisis and the Japanese experience in the same decade, even the bankers' panic of 1907. The purpose of all this archive-hunting is to underline the severity of the current turbulence. But the lesson for regulators should be that the system is hardwired to run into trouble at regular intervals.

Their first priority, rightly, has been to achieve a safe landing. Attention has focused largely on what industry veterans like to call circuit-breakers: ways of interrupting the downward momentum in sentiment and prices that fuelled the crisis.

It makes sense not to be too quick to overhaul the rulebook. Some argue, for example, that the much-maligned discipline of fair-value accounting may yet bring a swift end to the crisis: if prices have overshot on the way down, they may bounce back up again pretty quickly. Others point out that even enforcing current rules, by requiring banks to take on more capital because the riskiness of their asset base has gone up, may make matters much worse.

Besides, a big rethink of the industry's regulatory infrastructure, in the shape of the Basel 2 accord on capital adequacy, has only just been completed. Opinions vary on how much difference Basel 2 would have made to the current crisis had it already been in force, but hardly anyone believes that Basel 1 was better than the new accord. And whatever the merits of these debates, the new regime does have the great advantage of flexibility. Basel 2 has three main components, known as “pillars”. Pillar 1 is the mathematical bit, the calculation of the amount of capital that banks must set aside for credit risk, market risk and operational risk. This is the part of Basel 2 that has got the most attention prior to its implementation (at the start of this year in Europe, next year in America).

Regulators have now deftly shifted their ground to play up pillars 2 and 3. Pillar 2 not only covers other types of risk that have been to the fore in this crisis, such as reputational risk, but it also acts as a kind of manual override for regulators, allowing them to step in and impose additional capital requirements if needed. Pillar 3 is designed to improve the quality of banks' disclosure on their risk profiles. Whatever the flaws of Basel 2, it provides an infrastructure that makes it easier for regulators to respond to rising risk and makes it harder for banks to game the rules.

The rulebook may not have to be ripped up, but substantial change is still needed. Some will be country-specific. Britain now understands the benefits of having an effective regime for shutting down failing

banks and of maintaining a sensible deposit-insurance scheme, thanks to the Northern Rock fiasco. America is planning to streamline its supervisory system to remedy a confusing fragmentation of regulatory authority. It will also tighten up the mortgage-underwriting process, a point of massive vulnerability because trouble there weakens the entire superstructure of credit derivatives.

International regulators have also issued a blizzard of reports in response to the crisis. Some of their recommendations are technical, dealing with the specific causes of the credit crunch: the Basel Committee announced in April, for example, that it plans to levy higher capital charges on complex structured products and on credit assets held in banks' trading books.

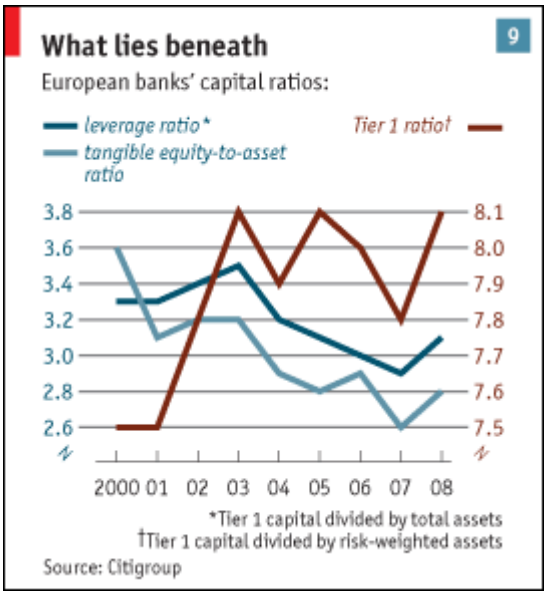
But other areas of regulatory debate are much more doctrinal. Four big questions stand out. One is how to treat liquidity; a second when to clamp down on risks in the financial system; a third where those risks are concentrated. The fourth question is whether a principles-based approach to regulation is better than a rules-based one.

Start with liquidity, the obvious gap in the regulatory firewall. Liquidity risk is barely mentioned in the Basel 2 accord, largely because capital and liquidity were seen as separate (if entwined). The Basel rulemakers are due to issue an updated set of liquidity standards later this year, but devising a sensible regime is no easy task. “Liquidity risk is a kind of catastrophic risk—you either have it or you don't,” says a senior regulator. The effectiveness of the policies that are in place to manage any emergency, such as deposit insurance and central-bank funding, will therefore help to determine how well the system deals with liquidity stresses.

Regulators clearly need to do more than wait for disaster to strike. For example, they have to take a view on a bank's optimal funding profile: the growing dependence of European banks on wholesale market funding left them increasingly vulnerable to liquidity drying up. The rulemakers also have to be more vigilant about maturity mismatches between banks' assets and liabilities, which entails looking at cashflows in off-balance-sheet vehicles as well on the balance sheet. And they are reviewing assumptions about how long the banks should be able to keep going without access to new funding, and what collateral central banks can accept to enable them to do so.

Regulators will also pay closer attention to how banks manage liquidity internally. At Deutsche Bank, for example, the treasury function had lost its status as a profit centre even before the crisis struck and liquidity had become part of the risk fief. Hugo Banziger, the bank's chief risk officer, says that this structure has given him a more complete picture of the crisis as it has evolved.

The second area of debate is on the timing of risk. Regulatory regimes that are based on market prices implicitly assume that risk goes down when the markets are doing well. The value-at-risk measure is the most obvious example. It demands less capital from banks when the data show a longer period of calm, and more capital when markets have become volatile. But that assumption makes little sense. Busts follow booms, after all. “Financial crashes are not random; they occur just after the top of the economic cycle,” says Mr Persaud of Intelligence Capital. The credit crunch scarcely came as a shock, even if its scale may have surprised many people. Regulators and market participants were all well aware that too much credit was being doled out too cheaply, yet models showed that risk-weighted capital ratios were healthy (see chart 9).



Leaning or cleaning?

Mr Persaud and other critics of the Basel 2 regime have long argued that it is “procyclical”, reinforcing trends rather than counterbalancing them. Many people's main concern has been about the period when the cycle turns down and raising capital requirements may force banks to cut their lending. But regulators are also looking at the period before the downturn when risks are building up, and wondering whether to fortify defences at that point.

Such a change in emphasis is particularly desirable because of the plethora of other procyclical forces now at work in the financial system. From mark-to-market accounting and illiquid products to credit-default swaps and speculative traders, the tendency for both booms and busts to feed on themselves has increased. That argues both for greater forbearance when the cycle turns and for a switch in emphasis from crisis mitigation toward crisis prevention. Put another way, there is a much greater need to take the top off booms (though not to avoid them altogether). “There is a choice between leaning against excesses and trying to clean up after them: the former has a much greater chance of encouraging better behaviour,” says Bill White of the Bank for International Settlements.

The Bank of Spain is already a useful advertisement for this “countercyclical” approach to bank regulation (see article), and others are becoming persuaded. The Financial Stability Forum, a group of industry bigwigs, identified the need for forward-looking capital buffers in the report it made to G7 ministers in April. The precise mechanism still needs to be worked out, and nobody pretends the method would be foolproof (particularly if monetary policy pointed the other way). But the logic of building defences before they are needed rather than after the event is hard to fault.

The third doctrinal question with which regulators are now wrestling relates to where risks are concentrated. The reason that banks ended up with so many off-balance-sheet vehicles was that the Basel 1 regime assumed that risk had been transferred and charged less capital as a result. Basel 2 does a much better job of charging banks for exposures to such vehicles, but could go further still.

Prudential panorama

For example, regulators need to take account of the pressures that banks felt to keep up their reputations by taking assets back onto their balance-sheets. That means more robust stress-testing of off-balance-sheet commitments, both formal and informal, and imposing higher capital charges where necessary. The Basel Committee has said it will publish new proposals on this topic later this year.

A wider view of risk concentrations is needed at the systemic level as well as for individual institutions. That does not mean expanding the regulatory net to include every hedge fund under the sun, but it does mean keeping tabs on institutions with the capacity to create problems, the role now envisaged for the Federal Reserve under reforms announced by America's Treasury at the end of March.

Illustration by Simon Pemberton

This clearly includes the investment banks. One of the most important lessons of this crisis to date is that even the smallest investment bank on Wall Street was too entangled to fail: Bear Stearns had to be saved. The authorities in America have yet to commit themselves to a system that would give the Fed permanent oversight of the investment banks, which are currently under the auspices of the Securities and Exchange Commission (SEC). Under Treasury plans, that authority will kick in temporarily and only when the banks represent a threat to the system.

This raises two concerns. The first relates to timing: as outlined above, it is the behaviour of financial institutions when risks appear low that creates the threat. The second concern relates to moral hazard: if investment banks have access to the same central-bank funding as commercial banks and represent just as much of a threat to the stability of the financial system, they should surely be subject to the same prudential and capital standards.

The fourth and final area of debate centres on whether regulatory regimes should be based on rules or principles. Those who support a more formulaic approach think that a system based on principles leaves too much room for the banks to wriggle free of their obligations. Those who support principles say much the same thing: precise rules are inflexible and more easily gamed. In truth, a blend is needed.

That means having more than one measure of capital, says Simon Samuels, a banking analyst at Citigroup. The leverage ratio, a conservative measure of capital that does not allow for any risk-weighting of assets, could provide an incentive to load up on riskier assets if it made no distinction between safe bets and wild ones. Having a second, risk-adjusted, measure of capital removes that incentive. Similarly, the problem with having only a risk-weighted capital measure is that capital can slide

too far because risks appear to be too low; the leverage ratio keeps the bar above a certain level come what may.

However they are resolved, the outcome of all these debates will be a more stringent approach to liquidity and capital. That has a cost: it makes credit more expensive. Given that it has been too cheap, this can be desirable, but things can easily tip too far in the other direction. Higher capital charges should not be used to make up for deficiencies in the quality of supervision. Regulators have to improve their own performance too.

That can be tough: higher pay makes more people want to be bankers than regulators. But as the self-flagellating report by Britain's Financial Services Authority (FSA) into the Northern Rock affair makes clear, regulators do not have to hire more mathematical geniuses to become more effective. Regular and rigorous contact with management and proper resources can make a huge difference to the quality of supervision. The FSA knew that a failure at Northern Rock would hurt, yet the watchdog decided in 2006 to extend the period between full-scale inspections of the bank from two years to three.

Occasional heavy-handedness can also have salutary effects. “What you have to do every so often”, says a former regulator, “is pick a performance measure of some kind, line the banks up and shoot the dog. The rest will quickly cower at the other end of the row.” Now that the crisis has helpfully shot some dogs, how might the banks line up in future?

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Spanish steps

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A simple way of curbing banks' greed

VERY few regulators emerge from this crisis looking good. The Americans did not see the poison from unregulated mortgage originators seeping into the credit system. The Germans did not spot the huge exposures to off-balance-sheet entities at various Landesbanks, and the Swiss missed the grenades strapped to UBS's investment-banking arm.

Following the Northern Rock affair, the reputation of Britain's Financial Services Authority (FSA) has taken the biggest knock of all the regulators. In Madrid, by contrast, a sense of quiet satisfaction prevails, thanks to two distinctive policies. One helped Spanish banks to avoid the worst of the subprime fallout and the other to prepare for the downside of an economic cycle.

The first was to demand that banks set aside the same amount of capital against assets in off-balance-sheet vehicles as they would against on-balance-sheet assets. That may not have squared with the rules of the outgoing Basel 1 accord, which offered capital relief on off-balance-sheet activities, but it did fit international accounting rules on consolidation. “We did not do anything special,” says Jose María Roldán, the head of banking regulation at the Bank of Spain. “SIVs looked like the business of the bank and did not transfer risk substantially.” The policy also reflected lessons learned during the country's own brush with banking disaster in the 1980s, when banks that looked fine in isolation turned out to be in dire straits when the accounts of parent groups were consolidated.

With no reason to set up SIVs, the Spanish banks did not bother. Other countries could have saved themselves a lot of trouble by taking a similarly rigorous view of consolidation. “In trying to dodge the rules, banks created a second and poorly capitalised banking system,” says Francisco González, chairman and chief executive of BBVA. “The Bank of Spain approach is a simple solution to the problem of too much leverage.”

The second policy does clash with international accounting standards. Since 2000 the Bank of Spain has had something called a “dynamic provisioning” regime, where bank provisions go up when lending is growing quickly. The scheme is based on the difference between banks' specific provisions for identified losses in any given year and a “statistical” provisioning amount that reflects average losses on assets over the whole business cycle. Over the cycle the effect is neutral, but the timing of the provisioning should make the troughs less deep and the peaks less vertiginous. “There is a gap between when risks are taken and when they materialise which needs to be bridged,” says Mr Roldán.

The banks themselves support these rules (although they doubtless moaned when they were introduced). Setters of accounting standards are less keen. In particular, the idea of a statistical provision flies in the face of IAS39, an accounting rule that requires provisions to reflect the specific losses expected on assets.

Clearly the Spanish authorities do not have all the answers. The country's housing market is cooling rapidly after a lending boom which the dynamic-provisioning regime could not prevent. Observers worry about the vulnerability of the country's regional savings banks. The statistical provision, which the Spanish banks calculated using data from two business cycles, is based on the assumption that all cycles are roughly similar, which they plainly are not. Liquidity is drying up: in the years before the crunch Spanish banks had come to rely more on wholesale markets for funding, and many have turned to the European Central Bank for help.

All the same, fellow regulators are now beginning to pay attention to what the Bank of Spain is doing. It would be ironic if the accountants forced Spain to change its tune just when other countries are beginning to hum along with it.

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Paradise regained?

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Illustration by Simon Pemberton

The crisis may have chastened the industry, but for how long?

THE banking industry has grown explosively over the past 25 years: America's financial-services industry accounted for 40% of the country's corporate profits last year, up from a mere 10% in the early 1980s. The rewards have been equally huge. According to McKinsey, the profits posted by American banks in 2006 were larger than the profits of the global retailing, pharmaceutical and automotive sectors combined. A long period of retrenchment now looms.

Fixed-income revenues will be hobbled for the foreseeable future, and when securitisation returns, it will be in a more muted form. Levels of leverage will drop, and profits will fall in tandem, particularly at the investment banks. According to Morgan Stanley and Oliver Wyman, leverage is thought to have driven almost half of the growth in their return on equity between 2003 and 2007. Even so, there are several reasons to be cheerful about the fundamentals of the industry.

The first of those reasons is already apparent in banks' financial results. Even as Western institutions were battered by losses in structured credit, other parts of the business were performing to record levels. In particular, revenues from emerging markets delivered a healthy boost to even the most anaemic global banks.

Demand from developing countries is the most obvious source of growth for the industry as a whole in the coming years. According to McKinsey's calculations, banks derived 80% of their revenues from developed countries in 2006, even though these markets accounted for only 71% of global GDP.

The second reason is demographic. Everybody knows that many countries' populations are ageing, but the figures can still be startling: recent projections from Paternoster, an insurance company, suggest that as many as half of the 30-year-olds in Britain could live to see their hundredth birthday. That promises a secure future for the financial providers who will be investing all that pension money.

The old are not the only source of capital that needs to be put to work. Sovereign-wealth funds do not have a brilliant record of picking the bottom of a bear market (they have lost billions on investments in financial institutions since last summer) but they can afford to make a few mistakes. Current estimates put their wealth at almost $3 trillion, and over the next five years or so that number is set to zoom above $10 trillion. Better still, this is real money, not the leveraged sort.

The third stimulus to growth is growth itself. Research by Morgan Stanley and Oliver Wyman shows that growth in investment banking in particular is closely correlated with rises in global GDP and equities, as well as with a steepening yield curve. If the world economy remains in relatively decent shape, banks will benefit.

These secular forces are complemented by two others. One is the industry's resilience. Investment banks, which hold risks for less time than other banks, have a particularly strong record of bouncing back from the edge. That can sometimes cause irritation: structured-credit whizz-kids are recasting themselves as experts in distressed assets. But it is hard not to admire their chutzpah. “This is great for me,” says one banker specialising in equities. “I've rebranded equities as a level 1 asset [a highly liquid sort] and people love it.”

The other source of optimism lies in one of the lessons of the crunch. Some people used to argue that the banks had lost their purpose because borrowers could bypass them and go straight to sources of capital. The crisis has delivered a very different message: that credit analysis remains critical to the functioning of the financial system, whether securitised or not. No other institutions have the infrastructure, the people, the data and the reputations that the banks can call on to carry out that task.

All change

None of this is to deny that there is plenty of pain ahead. Sources of funding at many banks will be rebalanced. Iceland's banks provide a clue to the measures that many will have to take. A liquidity hiccup in 2006 prompted the country's big three banks—Kaupthing, Glitnir and Landsbanki—to overhaul their financing. Kaupthing and Landsbanki both launched internet savings accounts that have helped push up the proportion of funding they get from retail deposits. They also lengthened the periods for which they can survive a liquidity freeze. “It would have been a nightmare to negotiate the crunch without the 2006 crisis,” says Sigurdur Einarsson, Kaupthing's chairman.

None of this is easy to do. Making sweeping changes to funding profiles is harder for larger banks, and funding will be more expensive for all banks as they fight for retail customers' money and issue costlier long-term debt into a market that will remain cautious about banks for a while yet. The threat of a liquidity freeze also means that both sides of the balance-sheet will now be more synchronised.

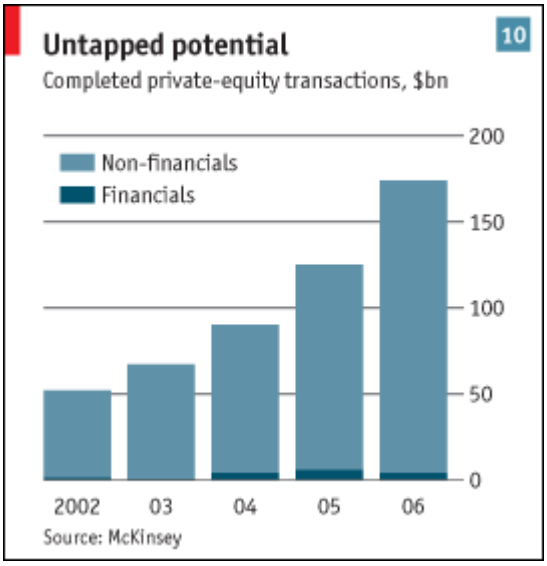
If the cost of banks' borrowing goes up, what will that do to their profits? Some costs will be passed on to customers as part of a general repricing of risk. Mr Profumo of UniCredit says that during the boom profitability was a minor detail for some institutions, particularly in corporate lending. The pre-crunch environment reminded him of one of his clients in his early days as a consultant. “He used to say that he lost €2 on each bottle of wine he sold, but the good news was that he sold a lot of bottles. Margins will become more important.”

In more competitive areas, it will be more difficult to pass costs on. In investment banking, it may mean a reduction in the amount of proprietary trading that institutions do. Jobs will be shed and pay will be lower. In retail banking the emphasis is likely to be on efficiency gains.

Irrespective of the regulatory response to the crisis, a strong capital base is going to be an important plus-point for banks for the foreseeable future. For those that have seen their capital cushions deflate over the past few months, the priority is to pump them back up again. That means more selective lending, in order to keep asset growth under control, and the grind of rebuilding capital through retained profits. It also signals more rights issues, particularly in Europe, where the decision in April by the Royal Bank of Scotland to raise £12 billion ($24 billion) has created pressure for others to follow. In some cases it will also mean M&A activity. The intriguing question is where new capital will come from, particularly for smaller banks. Many investors are now risk-averse or deleveraging, or both. Banks with lots of capital are in a strong position to deploy it but will be very careful with their due diligence.

All of which explains why many believe that private-equity firms are about to start making their presence felt. To date, private equity has had only a minor role as an investor in the financial-services industry (see chart 10), in large part because their traditional technique of buying firms and gearing them up does not work in an industry that is already highly leveraged. The environment now is different: since leverage is not much of an option in any industry at the moment, the banks look more attractive than they did. Prices are low (though people are also less willing to sell at the bottom of the market). And there is plenty of scope to improve performance with operational changes.

Money is being stockpiled. TPG and JC Flowers, two high-profile private-equity firms, have both formed new funds to invest in distressed financial companies (and reportedly attracted lots of cash from sovereign-wealth funds). TPG took a $2 billion minority stake in Washington Mutual, an American thrift, in April. Yet the impact of private equity on the banking industry is likely to be contained. Regulators are predictably nervous about the idea of leveraged entities owning other leveraged entities, and the biggest banks are out of reach.



A greater emphasis on capital and liquidity will have consequences for the business models of many banks, too. Some regulators have wondered aloud whether it was such a good idea to have repealed the Glass-Steagall act, a 1933 law which separated commercial and investment banking. Yet it is hard to see what this division would have done to prevent the crisis: the more focused institutions, on both the investment-banking and retail-banking wings of the industry, were the ones that got into most trouble. If anything, the government's decision to open the central bank's discount window to the investment banks, and its liking for private-sector rescues of ailing institutions, points away from restoring Glass-Steagall.

Individual institutions' routes out of the crisis will vary. Some will change shape. The management of UBS has already announced plans to scale back its investment-banking arm; it may yet be forced to split it off entirely. Vikram Pandit, Citigroup's chief executive, has been conducting a painstaking review into the bank's strategy and organisation and is set to downsize it.

Scale and hearty

Mr Pandit has affirmed his faith in the universal banking model, however, which looks stronger than ever. The crisis has made diversification look smart. Bear's exposure to the American market in general and to the mortgage market in particular was more pronounced than that of its peers, for example. American regional banks are expected to have a particularly torrid couple of years as credit conditions worsen in their confined backyards.

Deutsche Bank's Mr Banziger says that more diversified banks are better able to solve their own problems: “Like a jelly cube, they may wobble but they do not break. Smaller banks are like a matchstick: they snap.” An analysis by Boston Consulting Group of total shareholder returns at banks in the 12 months to November 2007 showed that, in general, the more diversified players performed better in this crisis than the less diversified ones.

Illustration by Simon Pemberton

Francisco González, the boss of BBVA, says that bigger banks not only enjoy the advantage of diversity but also have much more scope to sell off assets in times of trouble. In theory they should be better at credit analysis too, because they have more data to comb through and more opportunity to spread the cost of investment in things like IT systems.

The liquidity squeeze has pointed to the value of having stickier retail deposits, especially now that wholesale funding costs have rocketed. Universal banks have more wiggle-room in their treatment of assets than pure investment banks. Regulatory change may wipe out the investment banks' capital advantages. When securitisation makes a comeback, there will be benefits, even if only in reputation, to having commercial-banking skills under the same roof as investment-banking ones.

That said, the benefits of scale and diversification are much more apparent when the going is tough. According to Andrew Schwedel of Bain, a consultancy, pure investment banks and retail and commercial banks delivered greater returns to shareholders than did universal banks over the ten years to the end of 2006. “Glass and Steagall were better investors than regulators,” is the verdict of one industry veteran.

No business model can guarantee success or failure. The ranks of the bulge-bracket firms contained both Goldman Sachs, which has done well, and Bear Stearns, which no longer exists. The stable of universal banks includes both Citigroup, which has tottered from one disaster to the next, and HSBC, which now proudly tops the list of the world's biggest companies, according to *Forbes* magazine. One square in the middle of Zurich is home to two banks, UBS and Credit Suisse, which have combined wealth management and investment banking to somewhat different effect.

Until the next time

Like a knot that tightens when you wriggle, however, the banking industry's response to a crisis often creates the next problem. Last time around, slack monetary policy, a slump in equities and a crisis in emerging markets resulted in a fixed-income boom centred on the world's most developed markets. If the lesson of this crisis is to bulk up, it is worth pondering the downsides of universal banks, and of bigger banks in general.

Clearly larger and more complex institutions are more difficult to manage. Universal banks, armed with their big balance sheets, are always likely to be less disciplined about extending credit, whether to traders inside the bank or clients dangling investment-banking fees. And there are doubts about the ability of the regulators to monitor and to save heftier banks, especially when they operate across borders.

Out of the current turmoil may come some good, in the shape of a more sophisticated understanding of risk, a more transparent system of securitisation and a greater awareness of the incentives embedded in pay structures, as well as a new approach to regulation that ties capital and liquidity requirements to the risks banks take throughout the cycle. Just do not expect it to produce a permanent solution to the problem of financial excess.

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The next crisis

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Cross-border supervision needs more attention

THERE is always a bright side. To date, the banks that have imploded as a result of the credit crunch have been largely domestic. It has been clear from the start which national authority is responsible for clearing up the mess. The remarkable rescue of Bear Stearns by the Fed over a single weekend is testament to what a determined regulator can achieve. If a large international bank went belly-up, things would be far murkier. “So far we've been lucky,” says the chairman of one national regulator. “There is no formal framework for solving a cross-border crisis.”

It may not be entirely down to luck: banks operating in just one country are more likely to get into serious trouble than ones with an international spread of business. But the crisis may encourage more banks to diversify across borders, so the question of how the authorities would work together if a big bank were to fail will become more pressing.

When things are going well, dialogue is relatively easy. Bilateral relationships between home regulators (who have primary responsibility for supervision) and host regulators are generally healthy. In Europe, the Committee of European Banking Supervisors has been running a project for a handful of cross-border banks in which their principal regulators have formed supervisory colleges to share information and conduct joint inspections. There is much more of this sort of thing to come. In April European Union finance ministers signed an agreement to tighten up monitoring of the continent's big cross-border banks. American and British officials are keen to install a transatlantic watchdog.

Working out whose job it would be to save a border-crossing bank in trouble is far more contentious. Would taxpayers in a bank's home country stump up for the cost of rescuing its operations abroad?

“If a bank is systemically important at home, the authorities would have an incentive to intervene to ensure an orderly resolution, thereby also directly or indirectly supporting its operations abroad,” reckons Mr Borio of the Bank for International Settlements. Yet crisis simulations involving the supervisors of Nordea, a bank that has a substantial market share in four Scandinavian countries, suggest that co-ordination problems are thorny. “The exercises are great fun but have terrible outcomes,” says one observer.

In cross-border banking, institutions that are “too big to fail” are not the only problem. There are also those that are “too big to save”: big banks in small countries whose coffers could not cope with the cost of a bail-out. UBS and Credit Suisse, two Swiss banks with a sprawling international presence, are firmly in this camp. Swiss officials shrug nervously when asked what would happen if either of these two giants were felled.

And then there are those that might be described as “too small to fail”: banks that are not systemically important in their home market but wield lots of clout in foreign markets. Take a bank like Standard Chartered, which has its headquarters in London but makes its money in emerging markets. Would British taxpayers and regulators step in if the bank's operations in, say, Asia went wrong? Many countries in Eastern Europe have banking systems dominated by foreigners (see chart 11). The authorities in New Zealand, where much of the banking system is in Australian hands, require foreign branches above a certain size to incorporate locally and to appoint local boards.

Agreeing burden-sharing arrangements for cross-border institutions in advance is tough. Most regulators believe that decisions on funding and the like will have to be thrashed out when the time comes. But the cack-handed rescues of Britain's Northern Rock and Germany's IKB hardly inspire trust. In an

industry where crises unfold at high speed and confidence is all, hoping for the best is not much of a strategy.

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Offer to readers

May 15th 2008
From The Economist print edition

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Pharmaceuticals

Quagmire to goldmine?

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Illustration by David Simonds

The rapid growth in developing countries prompts a rethink by drugs companies

BRAZIL has long been a thorn in the side of the global drugs companies. The country's vibrant generics industry has often trampled over their patents. As recently as last year, its government threatened to invoke compulsory licensing (a legal mechanism that, in effect, legitimises such trampling) to browbeat a foreign drugs firm into offering huge discounts. And Brazil's state-funded researchers have devised some impressive drugs, including a new therapy for malaria (see article). Small wonder, then, that big drugs firms have remained leery of this market.

Indeed, they have been cautious about developing countries in general, which they have regarded as the source of many headaches and few profits. A decade ago Britain's GlaxoSmithKline (GSK) got a bloody nose in South Africa when it tried too vigorously to defend patents on an HIV drug. More recently Novartis, a Swiss firm, lost a bitter battle in India over patent protection for Gleevec, a profitable cancer drug. In Thailand the government has invoked compulsory licensing for some drugs. And next week the industry can expect another drubbing over patents harming “innovation for the poor” at the World Health Organisation's annual assembly.

But consider the story of Moksha8, a new drugs firm launched last month with money from Texas Pacific Group, a private-equity outfit. It aims to capitalise on Big Pharma's neglect of many emerging economies by striking licensing deals for branded drugs which it, in turn, intends to market to affluent customers in those countries. It already has some two dozen drugs under licence for Brazil from Roche and Pfizer. Fernando Reinach of Votorantim, a Brazilian firm that also invested in Moksha8, expects its annual sales to top $1 billion within a year or two.

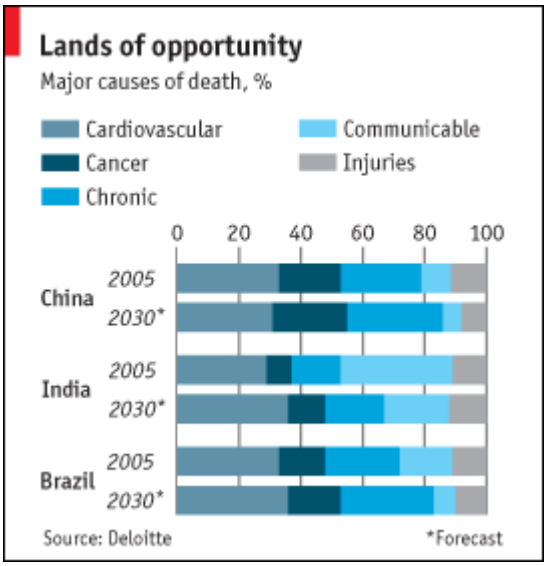
All of which suggests that the situation is ripe for change. For much of its history, the industry has focused chiefly on the diseases that afflict people in rich countries, while largely neglecting research into diseases of the poor. But as growth slows in developed markets, and the twin threats of generic drugs and price controls advance even in pharma-friendly America, drugs companies are thinking again.

That is not simply because governments in developing countries are wielding the big stick of busting patents: their expanding middle classes also provide a tantalising carrot. McKinsey, a consultancy, estimates that the value of the Indian drugs market will grow from $6.3 billion in 2005 to $20 billion in 2015. China's market is expected to soar even more spectacularly. Given such prospects for growth, says Mark Feinburg of Merck, an American drugs giant, “you've got to be in these markets—it's a great opportunity.”

G.V. Prasad, vice-chairman of Dr Reddy's, a successful Indian drugs firm that is evolving from copycat to innovator, is convinced that the thinking at Western firms is changing, and cites a recent reorganisation at GSK as evidence. Andrew Witty, who takes over as the firm's chief executive on May 22nd, wants to combine all its little divisions that deal with developing countries into one emerging-markets group, to be run by Abbas Hussain, whom he has just poached from Eli Lilly, a rival American firm.

Serving these markets will mean building up local expertise and research efforts. Where drugs firms have set up shop in developing markets, it has generally been to cut costs, rather than to cater to the needs of locals. But that is changing. Novartis has opened a research centre in Shanghai and has another outpost in Singapore focused on tropical diseases. Merck has struck several deals with firms in emerging markets to do early-stage research. The drugs giants argue that this new approach allows them to tap a global network of innovation, and also provides insights into local markets.

Paul Herrling of Novartis points out that virally induced cancers are rare in Europe but common in China. Terry Hisey of Deloitte, a consultancy, notes that Asians and Europeans can respond differently to anaesthesia. “We see China and India as research-and-development partners, and partnerships can help us learn how to do business there,” says Robert Court of GSK.



New thinking is also needed when deciding how to sell drugs in developing countries. In the past Western firms either ignored such countries or saw them as charity cases. But now, says Tachi Yamada of the Gates Foundation, who was at GSK when the firm faced the South African backlash over HIV drugs, “pharma companies can't possibly survive without recognising their responsibilities to the poor.”

Some firms have adopted “differential pricing” schemes that use formulas, based on average income per head, to set lower prices in poor countries. Merck, for example, recently launched Januvia, a blockbuster diabetes drug, in India for a fraction of the price it charges in America. But in future, says Prashant Yadav of the Massachusetts Institute of Technology, firms must “price differentially not between OECD and developing-country markets, but within each developing-country market.” In other words, middle-class Indian patients will pay more than the rural poor.

Both Novartis and GSK say they are thinking along these lines. But is there not a danger that cheap drugs intended for the poorest will be pilfered and sold at a profit to the urban middle classes, or shipped overseas to rich countries? This has been the standard argument against differential pricing from the drugs companies.

Once again attitudes are shifting. Some diversion will happen, but firms that have tried tiered pricing have found ways to reduce it. Just changing the colour of a pill can help. So too can after-market checks on distributors and pharmacists by drugs companies: those selling looted products may be cut off from future distribution. Nan Wang of Sinovac Biotech, a Chinese vaccine firm, says her company has long sold the same vaccine at lower prices in poor parts of China than in rich cities; the two versions have different packaging.

But not everyone is convinced. “In the absence of competition, differential pricing is a hoax,” scoffs Yusuf Hamied, chairman of Cipla, an Indian generics firm. In his view, only generics-makers like his firm provide genuine competition to Big Pharma, which he insists should have no patent rights in poor countries. Even if the drugs giants really have changed their approach to the developing world, the arguments over their rights and responsibilities will continue to rage.

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Hewlett-Packard

Now services

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Having bested Dell for the time being, Hewlett-Packard takes on IBM

DURING the first half of this decade Carly Fiorina, then boss of Hewlett-Packard (HP), was forever answering the same frustrating questions about Dell and IBM, HP's two more successful rivals. Dell, she said, offered computers that were “low-tech and low-cost”, whereas IBM offered “high-tech and high-cost”. Only HP, she said, was preparing to give customers “high-tech and low-cost”.

It was easier said than done. When Ms Fiorina tried to buy the computer-services arm of PricewaterhouseCoopers in 2000 to compete with IBM, the leader in that field, IBM beat her to it. And when she bought Compaq to take on Dell, the leading PC-maker, shareholders revolted. In 2005 the board fired her and hired Mark Hurd, a disciplined operations type, to focus on execution rather than vision.

Three years on Mr Hurd has mostly done that. HP, having fully digested Compaq at last, has surpassed Dell to become the world's biggest PC-maker. This means that Mr Hurd is now ready to take on IBM, which has more than 7% of the $748 billion market for services, such as running the data centres of large companies and governments, or handling entire functions, such as personnel or claims processing. The second-largest services firm, Electronic Data Systems (EDS), has much lower profit margins. HP lags in fifth place.

Mr Hurd's answer, announced this week, is to buy EDS for $13.9 billion. He is getting a big name: EDS, founded by Ross Perot in 1962, pioneered the business of outsourced data-management. But the company has been through turbulent times. Mr Perot sold EDS to General Motors in 1984—an unhappy combination that ended in 1996, when EDS was spun off. It then suffered during the technology bust and made a big loss. Under a new boss, it went into profit again, but with unimpressive margins. Its subsequent boss, Ronald Rittenmeyer, will now become head of the combined services arm of EDS and HP, which will be almost as large as IBM's.

The prospect of digesting yet another big acquisition after Compaq may seem daunting. Middle managers at HP still subscribe to the gentle, collegiate “HP way” of doing things. The culture is that of Silicon Valley—relaxed and casual—and the cafeteria is big on ahi tuna. At EDS, based in Plano, Texas, the style is “military, buttoned-down, and staid,” says Rick Sturm, the founder of Enterprise Management Associates, a consultancy. People wear ties. The cafeteria is full of steak and fries. Compared with other services firms, which increasingly hire and operate in India, EDS is overwhelmingly American.

Mr Hurd, who came to California from Ohio, is likely to feel the culture clash less than his colleagues in the ranks. His demeanour makes him “an EDS guy sitting on top of the HP way,” says one consultant. Culture aside, EDS's big selling point is to be the largest services firm that is independent of any hardware or software vendor. It will continue to advise clients to buy systems from all vendors, says Mr Hurd, but those clients are now likely to pay more attention when the boxes come from HP.

Nonetheless, the deal marks another step in HP's impressive comeback. This week Mr Hurd increased his estimate of this year's revenues to over $114 billion, despite the weak economy. The verdict on Mr Hurd is that he has skilfully executed the strategy of his flamboyant predecessor. The verdict on that predecessor, Ms Fiorina, has also improved. Her idea was controversial, but apparently right. Fittingly, Ms Fiorina seems to be making her own comeback now. As a supporter of John McCain, she is playing a bigger role in his presidential campaign by the week.

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Private equity

All Clear?

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What this week's Clear Channel deal says about the state of private equity

THE brinkmanship continued into the courtroom. But in the end, even as a partner of Bain Capital, a private-equity giant, was testifying before a New York judge on May 13th, a consortium of big banks decided after all to provide the financing to take Clear Channel Communications, a media giant, private. After credit started to crunch last summer, the banks—Citigroup, Deutsche, Morgan Stanley, Credit Suisse, Royal Bank of Scotland and Wachovia—tried to wriggle out of their commitment to provide debt to Bain and its partner, Thomas H. Lee Partners, citing the "material adverse change" (MAC) clause found in every financing contract.

The decision to settle seems sensible. "There are considerable legal ambiguities around MAC clauses," says Michael Ryan, a private-equity lawyer at Cleary Gottlieb Steen & Hamilton. In the end the banks agreed to finance a deal that values Clear Channel at $18 billion, down from the $19.4 billion approved by shareholders last September, so everybody gave a little ground. Shareholders are expected to agree to the new price.

The banks' threat to walk away was the product of the extreme stress they were under during the credit crunch, and the settlement is a sign that normality is returning—and with it the realisation by banks and private-equity firms alike that they have a strong mutual interest in getting the lucrative private-equity bandwagon moving again as soon as possible. The first steps towards doing that are clearing the backlog of uncompleted deals and getting rid of the overhang of private-equity debt that banks have had to keep on their balance sheets when the expected buyers for it suddenly withdrew because of the lack of access to credit.

The biggest deal still to be sorted out is the $33 billion sale of BCE, a Canadian telecoms firm. Some deals have already been abandoned, such as the sale of Sallie Mae, a student-loan company, and many others have been renegotiated. There has been a lot of manoeuvring on both sides of deals, says Franci Blassberg, a private-equity lawyer at Debevoise & Plimpton. For boards of companies that are waiting for their sales to private equity to be completed, one of the wisest strategies may be to wait, she says, because "if they press the issue now, whilst banks are stressed, the outcome is unlikely to be smooth, whereas things may be far better in a few months."

Rumours of the death of private equity are proving to be greatly exaggerated. The leading firms, in particular, have continued to raise impressive amounts of new money, largely from institutional investors. There is no sign of a return of the megadeals that had become almost routine before the credit bubble burst last year, but private-equity firms, and their lawyers, have been extremely active. True, some of this activity is most notable for its creativity. For instance, there have been several cases in which one private-equity owner has sold a 49% stake in a firm in its portfolio to another private-equity firm. This allows the seller to realise a profit while allowing the existing debt financing to remain in place, sparing the new owner from having to refinance the deal.

Private-equity firms have also been buying up much of the private-equity debt held by the banks—often borrowing from the bank to do so. A hypothetical example of such a deal: a bank sells debt with a nominal value of $10 billion to a private-equity firm or consortium for $8 billion, lending the buyers $7 billion towards the price. The bank takes a $2 billion write-down, but reduces its overhang of non-performing debt and gets an additional $1 billion of equity, moving it one step back towards resuming normal activities. Meanwhile, the private-equity firm buys debt at a fire-sale price, and will probably end up making a killing.

The same may be true for private-equity firms with expertise in distressed banks, notably Texas Pacific Group, Apollo and J.C. Flowers, which are investing in financial-services firms badly hit by the credit crisis. There is also plenty of investment in established firms (without taking a controlling stake) and in infrastructure.

But the change in focus is leaving private-equity firms with “organisational issues”, says Josh Lerner of Harvard Business School. This is especially true of the biggest firms, which had expanded rapidly in recent years on the assumption they would be handling two or three megadeals a quarter. Different skills are needed to handle today's private-equity activity, and that of the next year or two. So even as business picks up, it will be no surprise if for the first time ever, big private-equity firms announce lay-offs.

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The art market

Signs of weakness

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Sotheby's

Stellar art-auction results in New York do not tell the full story

ON THE face of it, the art market is still booming—in spite of the credit crunch and fears of a recession. On May 14th a Francis Bacon triptych (above) sold for $86.3m, the highest price ever paid publicly for work by the artist, at an evening auction of post-war and contemporary art at Sotheby's in New York. The night before, “Benefits Supervisor Sleeping”, by Lucian Freud, another modern British painter, fetched $33.6m at Christie's, a record for a work by a living artist sold at auction; and a red-and-yellow Mark Rothko sold for $50.4m.

Auctions of Impressionist paintings a week earlier raked in similarly spectacular sums. One of Claude Monet's early paintings, “The Railway Bridge at Argenteuil”, fetched $41.5m at Christie's and a large Cubist painting by Fernand Léger sold for $39.2m at Sotheby's. Yet bidding for the Monet and for other important works was thin, with only two or three bidders competing. “A year ago you would have seen much more competitive bidding,” says Ian Peck, chief executive of Art Capital Group, a New York bank that provides financing to art dealers and collectors. This suggests that broader economic woes are starting to affect the art market, which had previously seemed immune.

Indeed, about one-third of works that were auctioned on May 6th and 7th were sold at or below the lowest estimated price. Overall takings were below expectations and lower than the total at comparable sales in the past couple of years. And bidding for the second-division artworks flogged during daytime auctions was sluggish at best. “Bids for the superstructure of the art market are still high, but the foundation is weakening,” says Matthew Rutenberg, an art historian in New York.

In anticipation of tougher times to come, Sotheby's and Christie's, the duopoly at the top of the art-auction world, are being much more careful about offering guarantees—agreements to buy a work if it fails to sell for more than a specified minimum price. The credit crisis means they are finding it harder to farm out the associated risk, and they are no longer prepared to sit on expensive works that fail to sell.

On May 9th Sotheby's disappointed investors with a first-quarter net loss of $12.4m. The company blamed lower commission margins, higher expenses and fewer lucrative single-owner sales. It noted that it often makes a loss in the first quarter because it is a slow season, and has recently increased commissions to boost revenue. Even so, Wedbush Morgan Securities, an investment bank, recently downgraded Sotheby's shares. Whatever you think about Bacon's gloomy pictures, the outlook for the art market does not look pretty.

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Supply-chain management

Shrink rapped

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America's food retailers should wage a tougher war on waste

WALK into almost any big supermarket in America and you will find a cornucopia of food. The mountains of fresh produce on display are a testament to shoppers' desire for choice and freshness—and retailers' desire to relieve them of their dollars. But behind the mouth-watering offerings lies a distasteful reality: billions of dollars' worth of food is dumped each year because of retailers' inefficiency.

It is difficult to gauge quite how much waste—known as “shrink” in the industry's jargon—there is. Oliver Wyman, a consulting firm, puts the figure at 8-10% of total “perishable” goods in America. The Food Marketing Institute, an industry body, says such sales totalled $196 billion in 2006. That means food worth nearly $20 billion was dumped by retailers. In a report published on May 14th, the United Nations estimated that retailers and consumers in America throw away food worth $48 billion each year, and called upon governments everywhere to halve food wastage by 2025.

With food prices soaring and consumers tightening their belts, supermarkets' margins are under pressure. On May 13th Wal-Mart, America's biggest retailer, said its first-quarter sales rose by 10%, to $94 billion, but only after it slashed grocery prices by up to 30%. Its boss gave warning of harsher times ahead. Many retailers will need to cut costs, and tackling shrink seems a good way to do so.

Yet some firms are coy about the issue: Whole Foods, with sales of $6.6 billion and a reputation for fresh food, says its figures on waste are “proprietary”. Others point out that not all food is dumped. Kroger, a retailer based in Ohio with sales of $70 billion, gives 3,600 tons of fresh food a year to food banks.

Laudable though this is, it raises the question of why so much food is going to waste in the first place. After all, American supermarket chains have spent the past ten years or so installing inventory-management software, cold-storage systems and other supply-chain paraphernalia. Yet their shrink rates are still twice as big as those of European retailers.

One reason for this is structural, reckons Leigh Sparks of Stirling University in Britain. Food in America travels farther, increasing the risk it will rot in transit. Another reason is that American firms are less adept at capturing and using customer data to predict demand. And many American store managers believe high shrinkage is inevitable, given their enthusiasm for huge displays and the widest possible range of produce. “This feeds a vicious circle of more and more choice,” says Matthew Isotta of Oliver Wyman. And it can backfire if displays disguise rotten food or too much choice overwhelms customers.

A few firms have made a concerted effort to reduce shrink. One is Stop & Shop/Giant-Landover, a retailer with sales of $17 billion owned by Holland's Ahold. Launched in 2006, its initiative stressed that making its supply-chain leaner would enable the chain to offer customers the freshest possible products. This helped win over internal sceptics. “It really was a huge culture-shift for our people,” says José Alvarez, the firm's boss.

Stop & Shop looked across its entire fresh-food supply chain and reduced everything from the size of suppliers' boxes to the number of products on display, which fell by almost a fifth. Last year the chain cut shrink by almost a third, saving over $50m and eliminating 36,000 tons of rotten food, while improving customer satisfaction. Other retailers would do well to follow Stop & Shop's example—or watch as shrink takes an even bigger chunk out of their profits.

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Book clubs

The final chapter?

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The future looks bleak for an archaic corner of old media

EVERY year, across Spain, book-club salesmen knock on the doors of thousands of households. Those who fall for the pitch are then visited 21 times a year by agents from Circulo de Lectores, who bring catalogues of titles, take orders and deliver books. The club is owned by Bertelsmann, a German media firm, which dominates the market and earns revenues of more than €2 billion ($3.1 billion) from clubs in 21 countries. Many are largely unaltered since the 1970s, but that is about to change. Bertelsmann is selling its American clubs and has put the rest under strategic review. Book clubs are in for a radical overhaul at the very least—and some people think they are headed for extinction.

Book clubs thrived when book stores were scarce, and they once enjoyed huge memberships. Women are far more likely to be members of a book club than men; in France the typical member is a 44-year-old woman with two children who likes to read mass-market crime and romance novels, says Jörg Hagen, chief executive of Bertelsmann's local book club, France Loisirs. Its German club, Der Club, is popular with young families and older, traditionally minded “empty nesters” who enjoy German folk music. For many members, the club is their only source of books: roughly four-fifths of the members of Circulo de Lectores never go to a bookshop.

In recent years, however, membership has been declining. Some of Bertelsmann's book-club businesses have lost money for several years. Last year DirectGroup, its book-club division, made a profit of just €10m on sales of €2.6 billion. One problem is that books are now cheaply and readily available from big bookstore chains, supermarkets and the internet; another is that book clubs demand a financial commitment, an unattractive proposition for many people.

Bertelsmann has been trying a number of strategies to bring growth back to its book-club business, with some success. It has expanded in less developed markets such as Ukraine, where its club is the postal service's biggest customer. It has also tried adding bookshops and websites to its clubs, as France Loisirs has done. That lifts market share and profit margins, says Fernando Carro, chief executive of DirectGroup. In Germany he has successfully added new businesses to Der Club; members are now offered holidays to Turkey, lottery tickets and insurance, and the club is back in profit for the first time in years.

There is one kind of book club which could have a bright future: specialist clubs that harness the internet. Two successful new clubs in recent years have been Bertelsmann's Black Expressions in America, aimed at black women, and Mosaico, a Spanish-language club. For specialist titles, bookstores cannot compete for range with a book club, and the internet lacks the personal touch of a trusted team of editors. Roger Cooper, formerly editorial director of Bertelsmann's American book clubs, is involved in a new niche club, the Progressive Book Club, targeted at liberals. “I don't hold much hope for the future of mainstream book clubs,” he says. The Progressive Book Club, on the other hand, will exist purely online, will include blogs and will put members who live in the same community in touch with each other.

Ripplewood, an American private-equity firm that owns Readers Digest Association, a magazine company, is said to be interested in Bertelsmann's American clubs. In 2000 Thomas Middelhoff, Bertelsmann's chief executive at the time, nearly sold all its book clubs to Readers Digest, but the firm's founding family decided they could be turned around. Efforts by Mr Middelhoff's successor, Gunter Thielen, to restore growth to the book-club business were mostly unsuccessful, and insiders reckon Bertelsmann will have to sell it at a low price. Although the American clubs are in the most trouble, the French and Spanish clubs are “jewels”, says a former Bertelsmann executive, even though they are no longer growing. If this is the end of the story for book clubs, there are many who will mourn them.

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Aviation

Flying the flag

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Taking on Boeing and Airbus could be an expensive mistake for China

“THE Chinese people must use their own two hands and their wisdom to manufacture internationally competitive large aircraft. It is the will of the nation and all its people to have a Chinese large aircraft soar into the blue sky.” With these visionary words Wen Jiabao, China's prime minister, launched Commercial Aircraft Corporation of China (CACC) this week. Its mission is nothing less than to mount a challenge to the global duopoly of Europe's Airbus and America's Boeing.

It is the vast potential size of the Chinese domestic market that underpins Mr Wen's confidence in CACC. Joseph Nadol of JPMorgan forecasts that despite high fuel costs, passenger growth will continue at a double-digit clip before levelling off at around 9% a year in 2012. Airbus calculates that between 2007 and 2026, China will require 2,800 new passenger and freight planes. Why shouldn't China be making some of the planes to meet the demand generated by its booming economy?

CACC has inherited the existing ARJ21 regional-jet programme from AVIC I, a state-owned aviation firm that is one of CACC's main shareholders. The 70-seat jet, which will take to the air for the first time later this year, has already won 170 orders, nearly all from domestic Chinese airlines. CACC sees the ARJ21, and especially its forthcoming 90-seat variant, as a bridge to building a 200-seat rival to the single-aisle Airbus 320 and Boeing 737.

China's aviation industry has learnt a lot from making increasingly sophisticated parts for Boeing and Airbus over the past 20 years. China makes doors and some wing parts for the A320. It is also expected to build around 5% of the airframe of the new A350. Boeing sources not only doors and tailfins for the 737 from China, but also the rudder of its new 787 Dreamliner.

Within a few months AVIC I and its smaller state-owned rival AVIC II will take an important next step. In a joint venture with Airbus, they will start producing up to four A320s a month on a final-assembly line in the northern port city of Tianjin. The Chinese make no attempt to hide their delight over how much they expect to learn, while Airbus regards the inevitable transfer of intellectual property as a necessary cost of doing business—which should amount to more than 100 sales a year in China for the foreseeable future.

But even assuming the market stays buoyant and the massive technical and financial resources can be found to meet its goal of preparing a large plane for take-off by 2020, CACC's chances of commercial success are dauntingly low.

Wrapping a national flag around civil-aviation projects is a recipe for wasting money and dashing dreams. Last year Indonesia's national champion, PTDI, was declared bankrupt by the courts after losing money on every plane and helicopter it built. Worse still, its inferior products were foisted on Indonesia's airlines. Richard Aboulafia of Teal Group, an aviation consultancy, points out that the only example of an emerging-market producer succeeding is Embraer of Brazil—and for 30 years it too was “a cash-devouring horror”.

Although Boeing huffs and puffs about ensuring that China sticks to WTO rules banning market-distorting subsidies, both it and Airbus are studiously polite about the prospect of a new rival. Boeing says that competition has always been good for the business, and an Airbus spokesman describes it as “a natural ambition” for a country of China's size to make big jets.

Besides, by the time the Chinese have their A320/737 rival ready, Boeing and Airbus will be selling their next-generation single-aisle planes which will deliver a vast improvement in operating economics. And China's largely state-owned but highly competitive airlines have a record of resisting government pressure to buy planes they do not want. In the 1990s McDonnell Douglas and AVIC I established an assembly line to produce the American firm's ageing MD-90. Only two were built because Chinese airline

bosses preferred newer models from Boeing and Airbus.

A final reason to question whether the industrial policy behind the creation of CACC makes sense is that manufacturing big commercial aircraft has ceased to be a national enterprise. Boeing and Airbus increasingly rely on global supply chains and risk-sharing partners, some of which are involved from the design stage to produce not just components, but entire sections of planes. Paradoxically, no country is better placed to gain from these developments than China. The new distributed model has had some problems, as the delays to the 787 show, but neither Boeing nor Airbus would dream of going back to the old way of making planes. The Chinese insist they are playing a long game. The question is whether they should bother to play at all.

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Face value

Return to Rio

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AFP

How Antonio Brufau is turning a refiner and petrol retailer into a real oil company

MOST leading oilmen have climbed the greasy pole entirely within their industry; their discourse drips with geological jargon or crude statistics. Antonio Brufau, the boss of Repsol, Spain's largest oil company, is different. A Catalan economics graduate from Barcelona University, he stepped into the Anglo-Saxon business world as an accountant and partner at Arthur Andersen, before plunging back into the heart of Catalonia as managing director of La Caixa Group—not just Spain's best-known mutual savings bank, but a politically well connected outfit woven into the fabric of Spanish economic life. Its holding company pulls the strings in many powerful Spanish firms. Though his discreet style betrays his professional training and his Anglophilia, this is a man who knows how modern Spain operates: he knows, as it were, where the bodies are buried.

Until recently, Mr Brufau was also an unusual oilman in a more fundamental way. Compared with the global giants his firm, Repsol, had only a little gas and hardly any oil. “When I got here, the fridge was empty,” he says. Lack of reserves was bad enough, but in addition his predecessor's effort to fix the problem had just failed, leaving a pile of debt. Sorting out the mess had to take precedence over finding new reserves, and drilling for oil was virtually suspended. So in 2004, when he moved into the executive suite in Repsol's head office at the top end of Madrid's Paseo de la Castellana, Mr Brufau faced a daunting task.

Repsol's tower is now overlooked by huge new buildings, symbolising the economic changes that have swept through Spain in the past 25 years. The period has been turbulent and Repsol is only now emerging from it. In the early stages of Spain's long boom, the fashionable thing for Spanish firms was to expand into Central and South America. Banks, builders and telecoms firms all did it—and so did Repsol. Comforted by ties of language, history and culture, the Spanish firms expanded boldly, only to over-reach themselves, rather like the original Spanish empire. Along with the others, Repsol took a bath.

Its Latin American expansion was part of a strategy to transform a business that was really a collection of refinery and retail operations dating back to the statist Franco era. Starting in 1993, it tried to move upstream into exploration and production—the more profitable end of the oil industry. Today, for instance, although upstream production still accounts for only a fifth of revenues, it brings in half the profits. Moving upstream is a hard task at the best of times, but trying to do so in Latin America in the late 1990s was especially hazardous. Repsol paid $15 billion for YPF, an Argentine firm that had been partly privatised at the start of the decade. This doubled the size of the company, which changed its name to Repsol YPF.

But three years later the Argentine economy went into free fall. In the ensuing mess, Repsol was left with a pile of debt, raised for the purchase, and a South American business trapped in an economy being wiped out by hyperinflation. Price controls meant that YPF was forced to sell its oil and gas for one-third of what it could earn in export markets. So when he took over, Mr Brufau decided to reduce Repsol's exposure to Argentina. The solution, which he is pushing through despite the credit crunch, is to sell up to 25% of shares to Enrique Eskenazi, a local businessman, and to float a further 20% on the Buenos Aires stock exchange this summer. That way, says Mr Brufau, he will maintain an interest in Argentina in anticipation of better times.

The disposal and some smaller sales in South America are changing the shape of the group. Latin America accounted for only 38% of invested capital by the end of last year, compared with 52% when Mr Brufau took office. His ambitious strategy for the next four years aims to triple net profits while concentrating 55% of “core assets” in OECD countries. The company is tripling investment, mainly in ten big projects. Three of them are in Iberia, where Repsol will strengthen its downstream activities of refining, marketing and petrochemicals. Apart from its dominance in the Spanish and Portuguese refining and petrol-retailing business, Repsol is also strong in gas: it is the world's fourth largest producer of LPG and has a big stake in Gas Natural, the Catalan gas company. Repsol's reserves of oil and gas are now scattered around north and west Africa, the Caribbean and the Gulf of Mexico—as well as Argentina, Bolivia and Brazil.

Deus ex machina

Mr Brufau's strategy appears to be working. The share price has doubled since he arrived, debt is a manageable 12% or so of total equity, and profit margins are a healthy 10% on sales of €52 billion ($70 billion). And now another twist in Repsol's fortunes could be on the way. Despite Mr Brufau's strategy of reducing the group's reliance on Latin America, it bought a 25% stake in the Carioca field off Brazil, which looks like being a bonanza. Within the next few weeks Petrobras, the leader in the drilling consortium, says it will have some idea of how big the field really is, but it is thought to be one of the biggest finds in years.

With every new rumour about Carioca, the smiles in Paseo de la Castellana grow broader. Such good cheer goes some way to counter recent reverses Repsol has suffered as economic nationalism sweeps through oil- and gas-producing states. Bolivia has kicked Repsol and its partners out of an oilfield, and Algeria has ejected it from a $5 billion gas project. And this week Shell and Repsol pulled out of a $10 billion Iranian gas project, under pressure from America—though the companies say their withdrawal has been prompted by rising costs rather than political concerns, and they plan to rejoin the project later.

Either way, Mr Brufau can no longer be accused of being an oilman without any oil. As they say in Catalan, *de mica en mica s'omple la pica i de gota en gota s'omple la bóta:* little by little you fill the sink, drop by drop you fill the barrel.

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Travel and tourism

A new itinerary

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Reuters

Both as destinations and as new sources of tourists, emerging economies are transforming the travel industry

WHEN you arrive at Dubai International Airport, the bus journey from your aeroplane to the terminal building takes almost 15 minutes. This is not because Dubai is inefficient—far from it—but because for a small country it has a huge airport, which is in the throes of expansion. The airport will still be too small to cope with the swelling inflow of travellers, so Dubai's rulers are building another one, at Jebel Ali, a port town 35km (20 miles) away, which is due to come into full operation in 2017. Designed to handle 120m passengers a year, it is expected to be the world's busiest airport.

Booming emerging economies are the great hope of the world's travel and tourism industry. Dubai is the most shimmering example. It has only a tiny percentage of the United Arab Emirates' oil reserves, and so is straining to turn itself into a regional hub for finance, travel and high-class tourism. Three palm-shaped island-resorts are being built: the Palm Jumeirah (pictured), the Palm Jebel Ali and the Palm Deira. The Burj al-Arab, curved like a sail and on another artificial island, is the world's only seven-star hotel—with its own helipad, naturally. Dubai also boasts the Middle East's first indoor ski-slope.

About 30% of Dubai's GDP depends on travel and tourism, but Sheikh Mohammed bin Rashid Al Maktoum, Dubai's ruler, wants the industry to grow much more. He is the driving force behind the construction of Dubailand, a tourism and entertainment complex divided into seven theme worlds that are Dubai's answer to Disneyland. By 2015 Dubailand is aiming to attract 15m tourists, roughly 40,000 visitors daily.

No wonder, then, that last month the top brass of the World Travel & Tourism Council (WTTC), the industry's main lobby group, held their annual meeting amid Dubai's glitz. They might have found lots of reasons to be gloomy: a weak dollar, sky-high oil and food prices, looming recession in America and a credit crunch on both sides of the Atlantic. Yet the tourism barons were fairly chipper. They hope that Americans will still travel, albeit more parsimoniously. And they think that travellers to and from emerging economies will make up for some of the flagging *Wanderlust* of the developed world.

Ready for take-off

The rise of emerging economies marks the third revolution the travel industry has undergone in the past 50 years. The first came in the 1960s, in the shape of cheap air travel and package tours. Rising incomes enabled people of modest means to travel more, to farther-flung parts of the globe, and to take advantage of “all-in” offers that may have included sightseeing trips, scuba diving or camel rides. The second was the advent of the internet, which has allowed millions to book flights, hotels, hire cars and

package tours without going near a high-street travel agent.

Now fast-growing emerging economies—not just Dubai but also the BRICs (Brazil, Russia, India and China) and others, such as South Korea and Vietnam—are changing the world of travel once again, either as destinations or as sources of newly affluent travellers. Often, citizens of these countries are visiting similar, emerging lands. Last year, for example, Russians made a total of 34.3m trips abroad, up from 29.1m in 2006. Turkey was their most popular destination, followed by China and Egypt. The Chinese head the table of visitors to Vietnam.

The WTTC claims that travel and tourism is the world's biggest industry in terms of its contribution to global GDP and employment. The lobby group forecasts that global travel and tourism will account for $5.9 trillion of economic activity in 2008, or about 10% of global GDP, employing 238m people. It expects employment to rise to 296m in the next decade.

In fact, assessing the scale of the industry is not straightforward. When all travel and tourism is lumped together, so that everything from airlines to cafés counts, it is no surprise that the WTTC's total is so large. As a rule, restaurants do not record whether they are serving tourists, business travellers or locals out for a meal.

The United Nations World Tourism Organisation (UNWTO) has resorted to monitoring international tourist arrivals only. It therefore knows where tourists are going to, but has a much less accurate idea of where they have come from. Travel and tourism data from developing countries, in particular, are unreliable. And many of the industry's jobs, such as tour guides or souvenir salesmen, go unrecorded. Officially, the tourism business in Sicily is sizeable, but it would be bigger still if untaxed and undeclared jobs were counted.

Never mind the difficulties of definition and measurement: the industry, from any angle, is huge and growing. It accounts for a large part of many countries' foreign-exchange earnings. For many developing countries, it offers an important route out of poverty. And further expansion and democratisation of tourism, centred on emerging economies, is under way. Having once worked in tourism, an increasing number of citizens of those countries are beginning to become tourists themselves.

According to the UNWTO, international tourist arrivals grew by 6% last year, to 900m (see chart 1). The total has gone up by almost 100m in two years. Last year the Middle East welcomed 13% more international tourists, or 46m in all. Arrivals in Asia and the Pacific were up by 10%, to 185m—with much of the extra travel coming from elsewhere in the region. Africa saw an increase of 8%, to 44m. This year, the UNWTO predicts, growth of international tourism will be fastest in Asia and the Pacific.

Forecasts for growth are even less reliable than in other industries, partly because tourism is vulnerable to shocks such as natural disasters or terrorist attacks. José Antonio Tazón, boss of Amadeus, a travel-technology company, points out that global firms are less exposed than local ones. They can make up for lost business in a region affected by catastrophes with business in other parts of the world.

A dollar won't stretch that far

For the next year or two, the travel industry is likely to find its long-standing customers in rich Western countries a less than reliable source of growth. As American families plan their holidays, many will be worrying about the frailty of their country's economy, the rising cost of petrol and—for those venturing outside the United States—the weakness of the dollar. They are delaying booking in the hope of nabbing cheap, last-minute deals.

They certainly seem to be spending less. On May 7th Orbitz, an American online travel-firm, posted a first-quarter net loss of $15m compared with a net loss of $10m a year earlier. The mainstay of its business is domestic bookings, which were 6% lower in the first quarter than a year earlier, at $2.4 billion.

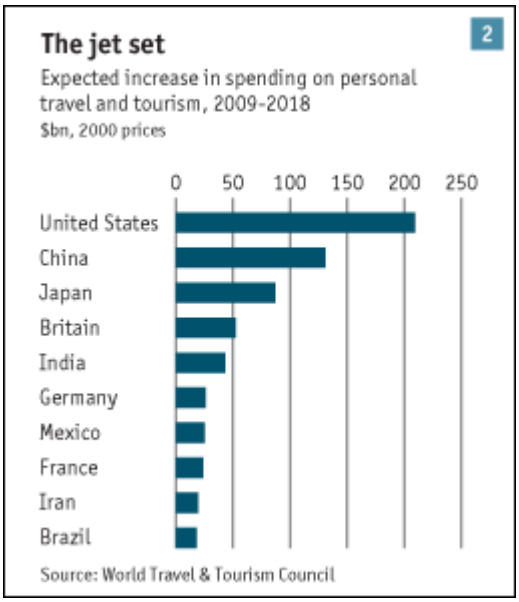
About 85% of American travel and tourism is domestic. Only one-fifth of American citizens have passports. Those thinking of going abroad will need more tempting than usual. Some hotels in European cities are offering deep discounts to American travellers to make up for the weakness of the dollar. WorldHotels, a hotel-marketing company, says that Americans can book rooms at a one-to-one euro-dollar exchange rate—a saving of roughly one-third at today's rate—at 52 of the European hotels on its books. Nevertheless, WorldHotels saw a 15% drop in business from Americans at its European hotels during the first quarter of this year.

Yet the industry remains confident that people will travel, even if they spend less. “One of the last bits of discretionary spending people cut is their holiday,” argues Thomas Middelhoff, chief executive of Arcandor, the German retailer that owns Thomas Cook, a travel company.

Some European travellers, by contrast, will at least have the benefit of a strong euro. Within the continent, there are other pluses. The expansion of low-cost airlines is boosting short-break travel. The extension of the passport-free Schengen area to nine more countries makes trips within Europe easier. The Euro 2008 football championship in Austria and Switzerland, the Zaragoza International Expo in Spain and Liverpool's reign as Europe's cultural capital are also expected to be good for business. That will help the European Union remain the biggest contributor to global travel and tourism, with 27.5% of the share of the world market and more than 10% of the industry's total workforce.

Even so, Europeans are likely to feel the slowdown of the economy and the impact of the high price of oil. British Airways recently upped its fuel surcharge, which now stands at £158 ($312) for a return long-haul flight to Britain. On May 7th easyJet, a low-cost airline, unveiled a £57.5m loss for the six months to the end of March. Granted, that is usually the company's weaker half-year, but the loss a year before had been only £17.1m. The trouble was the rising cost of fuel, which now accounts for 28% of easyJet's cost per seat. All this means tourism in the EU will grow by only about 2% this year, reckons the WTTC, compared with worldwide growth of 3-4%.

For faster growth, the industry will have to look to emerging economies. These are becoming increasingly well established as places to visit. Now they are starting to provide more visitors too. According to McKinsey, a consulting firm, by the middle of the next decade almost a billion people will see their annual household incomes rise beyond $5,000—roughly the threshold for spending money on discretionary goods and services rather than simple necessities. Consumers' spending power in emerging economies will rise from $4 trillion in 2006 to more than $9 trillion—nearly the spending power of western Europe today.



Some of that extra purchasing power will go on travel, at home and abroad (see chart 2). Western companies are flocking into the developing world to prepare for these new tourists. “The Middle East, India and China are the next big thing,” predicts Bill Marriott, the chairman and chief executive of Marriott, an American hotel chain. He thinks that the industry will be bigger in the Middle East, where he is planning to build 65 hotels by 2011, than in India. China will dwarf even the Middle East.

The new travellers

Last year the number of visits abroad by the Chinese reached 47m, 5m more than the number of foreign visitors to China. The Chinese also made 1.6 billion trips at home—a staggering total, but not much more than one each. According to WTTC forecasts, Chinese demand for travel and tourism will quadruple in value in the next ten years. At present China ranks a distant second, behind the United States, in terms of demand, but by 2018 it will have closed much of the gap.

Other emerging economies have woken up to the spending power of Chinese tourists. Mexico is one: AeroMéxico will begin direct flights between Mexico City and Shanghai at the end of May. The plan is to fly twice a week. In Vietnam, home to one of the fastest-growing tourist industries in the world, Chinese and other Asian tourists are overtaking Westerners. In the first 11 months of last year 507,000 visitors came to Vietnam from China, along with 442,000 from South Korea and 376,000 from America. The Tourism Authority of Thailand is also counting on more Chinese custom. It forecasts that 1.3m Chinese

will visit the country this year, 10% more than last year (when visitors were put off by Thailand's unsettled politics).

To speed up the development of tourism and other industries, the Chinese government is racing to build roads, railways and airports. In January it said that it planned to add 97 airports by 2020 to the 142 China had at the end of 2006. The number with an annual handling capacity of over 30m passengers will grow from three to 13. According to the state media, investment in infrastructure will see double-digit growth every year for the rest of the decade. Between 2006 and 2010, $200 billion is expected to have been invested in railways alone, four times more than in the previous five years. In June the world's longest sea-crossing bridge, a 36km six-lane highway across Hangzhou Bay, is due to open. This will halve the travel time between Ningbo and Shanghai, two of China's busiest ports, to about two hours.

Asia's other rising economic giant is lagging behind China, both as a source of tourists and as a tourist destination. Last year India had only 5.5m foreign visitors, a tiny share of the world market: the country of the Taj Mahal and the Himalayas ranks below Bulgaria and Bahrain. Fewer than 10m Indians travelled abroad, though about 600m Indians made trips at home. Andhra Pradesh, home of many religious sites, got the lion's share of visits, whereas foreigners flocked to Delhi and Maharashtra, India's most urbanised state. Travel on the subcontinent can be bewildering even for Indians, owing to more than 20 official languages and innumerable dialects. Many moan as much as foreigners do about uncomfortable transport, strange food, unusual bowel movements and the lack of decent hotel rooms.

The subcontinent's biggest problem is the poor state of much of its infrastructure. The government plans to spend more than 20 trillion rupees (around $500 billion) on infrastructure in the five years to 2012. India's tourism ministry says it spent 4.6 trillion rupees on 248 projects in the year to March. India's main airports are undergoing expensive facelifts with lots of private-sector money. Parts of Mumbai's Chhatrapati Shivaji International Airport are gleaming; but elsewhere people sit with their saris drawn over their mouths to stop themselves inhaling the dust as plasterboard is machine-sawn nearby. At Indira Gandhi airport in Delhi, immigration officials will think nothing of clocking off with four or five people left in the queue, who then have to go to the back of another line. An official will stamp a traveller's visa—and a few yards later a guard will check that it has indeed been stamped.

Some investors are backing the country's breathtaking beauty against all the inconvenience and bureaucracy. Marilyn Carlson Nelson, chief executive of Carlson, a privately owned travel group which owns Radisson hotels and Regent Seven Seas Cruises, sees great promise in India. Carlson is developing around 50 hotels in India compared with only ten in China. Manny Fontenla-Novoa, chief executive of Thomas Cook, a travel company, is equally optimistic about India's potential. In March Thomas Cook bought Thomas Cook India, the subcontinent's largest foreign-exchange and second-biggest travel business, dating back to the 1880s, from Dubai Financial Group. Joint ventures in Russia and China are next on Mr Fontenla-Novoa's list.

Clouds on the horizon

What might stop tourism's latest revolution? Political violence is one possibility. Developed countries are no strangers to terrorism, but the dangers in emerging economies are greater. This week's bomb attacks in Jaipur, a popular spot on the Indian tourist trail, are a bloody reminder. Kenya, a country that depends on tourism for much of its foreign income, lost about half its business in the wake of political violence after elections in December. Natural disasters are also likelier to cause worse devastation in poorer places. However, Mr Tazón of Amadeus points out that “the industry has proved to be very resilient.” It recovered quickly after the terrorist attacks on September 11th 2001, SARS, the outbreak of the war in Iraq and the tsunami in December 2004.

Another possible obstacle is the growing concern, especially in Western countries, with the environment. During the 1960s and 1970s, when tourism was growing explosively in American and Europe, few gave much thought to the consequences for the planet. That has changed. Philippe Bourguignon, vice-chairman of Revolution Places, a travel business, says that greenery cannot be dismissed as merely the flavour of the month.

The industry, which contributes 5-6% of all carbon emissions, seems worried. Green strategies are multiplying. In April Travelport, a travel-technology company, introduced the Travelport Carbon Tracker, which allows travel agencies and companies to measure and analyse carbon emissions and hence to help “sustainable travel decision-making”. Hotels are keen to show that they conserve water (do you really need a clean towel every day?), recycle rubbish, and save electricity by using low-energy light bulbs.

Airlines order less thirsty planes. Eco-spas powered by wind turbines and solar panels, and safaris based on conservation are vying for the customer with a green conscience.

Marriott's efforts are a case in point. In April the hotel firm and the Brazilian state of Amazonas signed an agreement to protect 1.4m acres of endangered Amazon rainforest in the Juma Sustainable Development Reserve. Marriott is chipping in $2m to pay for an environmental management plan administered by the newly created Amazonas Sustainable Foundation that will support employment, education and health care for the approximately 500 people who live in the Juma reserve. Over the next ten years Marriott aims to reduce energy and water consumption at its hotels by 25% by, for instance, introducing solar power at up to 40 hotels. “After years of lip service, companies like Marriott are really being proactive,” says Michael Johnson, dean of Cornell University's School of Hotel Administration.

For all this concern, emerging economies are much more interested in rapid growth than in ecology. And holidaymakers, wherever they are from, seem unwilling to give up flying or driving just yet. Mr Fontenla-Novoa sees little evidence that an environmental conscience plays a big part in customers' travel planning. Westerners have had their decades of fun. Now the rest of the world wants a turn.

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Finance in Asia

Pots and kettles

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Illustration by Satoshi Kambayashi

The credit crisis has cooled Asia's ardour towards Western banks. But the region stands to gain even more from opening up than Wall Street does

WHEN China's three leading state-run banks finally felt confident enough to list their shares in 2006 and 2007, after years of losses from bad lending practices, the initial public offerings contained two common elements: big Western banks acting first as underwriters and second as strategic investors. What the government most wanted was an endorsement of quality that it felt could come only from the cream of global banking. It was prepared to offer the lucky few the chance to make billions of dollars, in exchange for sharing what it thought was their invaluable risk-management expertise.

The offer of minority stakes was accompanied by a slight crack in the Great Wall that China has built around its highly sensitive securities markets. Last year Credit Suisse, Citigroup and Morgan Stanley all received enough encouragement from regulators to announce agreements with domestic securities firms for some form of tie-up. Meanwhile, China's new sovereign-wealth fund spent $3 billion on a stake in the Blackstone Group, an American buy-out fund, hoping to learn lessons in finance from a master of the craft.

All of this came before the credit crisis sideswiped the big Western financial firms, costing hundreds of billions of dollars in losses, the jobs of senior executives (not to mention those of thousands of more junior employees) and, most important, their reputations for prudent risk management. Optimists in Europe and America say that acknowledging these losses is all part of the healing process. But in parts of Asia there is a chillier interpretation. There you can find the belief that Western banks have failed an important test of soundness and that their regulatory model is not to be trusted either.

As a result, Western bankers say they are greeted more coolly than they were a year ago—not just in China, but in Japan and South Korea too. They point to Seoul's reluctance to endorse HSBC's acquisition of Korea Exchange Bank as one sign of frostiness. In China attitudes are hardening publicly. Credit Suisse, Citi and Morgan Stanley have not yet had their deals approved, and other banks that had hoped to be next now wonder if the approval process has been quietly shelved.

Unlike in many developed markets where government decisions are clearly explained, a rejection in China often comes in the maddening form of absolute silence. But strong hints are emerging. A senior Chinese regulator recently described to this newspaper his view of big global investment banks in one

unusually graphic word: “shit”.

There is particular scepticism about whether large Western banks, or their regulators, truly understand the risks associated with the mountain of derivatives on their balance sheets. Liu Mingkang, chairman of the China Banking Regulatory Commission (and a leading reformer), makes no attempt to conceal his doubts about bank regulation in America—and how flat-footed it was. “After the death, the doctor came,” he observes dryly. As a result, he indicates, China is likely to open up to international banks even more slowly than it has already.

Even as Western financial firms have fallen into disrepute, banks in emerging markets are treated as paragons of probity. Jiang Jianqing, chairman of Industrial and Commercial Bank of China, the world's most valuable bank, recently talked down the merits of investment in American bonds and banks. His bank has refused invitations to invest in global firms. Instead it has bought a large part of Standard Bank of South Africa and controlling shares in banks in Macau and Indonesia.

Some of the reaction is an understandable response to genuine failures. China's sovereign-wealth fund has lost plenty of money on its year-old Blackstone stake and on its investment in Morgan Stanley. But rather than viewing this as an education in the way an unrigged market works, or an opportunity to buy more at a lower price, it considers the investments an embarrassment. So far this year, China has not invested in any stricken Western banks; just in time, Citic, China's leading securities firm, slipped out of a billion-dollar investment in Bear Stearns before it fell into the arms of JPMorgan Chase.

In many ways, these are nerve-racking moments for institutions that have put great store by China. The potential spoils are huge. According to Matthew Austen of Oliver Wyman, a consultancy, the Chinese banking and securities market generates $225 billion in revenues; he reckons that Western firms receive no more than 7% of this (and less than 1% if shareholdings in Chinese companies are excluded). The global firms would like to manage funds, raise capital and trade securities, including shares, debt and derivatives. All these activities are still heavily restricted.

They are not the only ones likely to be hurt by rising protectionism, however. Hank Paulson, America's treasury secretary, was not just talking America's book when he said that opening the Chinese financial system is “absolutely necessary” for China's own long-term economic success. It would not only provide greater equilibrium to global capital flows, but would also bring more efficiency to China's industry. Already, manufacturing firms in southern China are struggling to cope with the rising yuan, because there is no currency-futures market for hedging.

Similarly, Chinese firms are forced into inefficient financing arrangements. They can borrow from state-controlled banks at rising rates that may have little to do with their own creditworthiness, let alone what they plan to do with the money. Alternatively, they can join a long, bureaucratic queue to issue shares. Even the largest ones still rely on the state for permission to raise capital: Ping An, the second-largest insurer, recently pulled a vast secondary share offering after what was believed to be a quiet word from the authorities.

A state-driven financial market means state firms tend to do best. Financing for start-ups remains largely informal—loans from friends outside the financial (and tax) system—which stifles entrepreneurship. Worst of all, today's system provides a truly rotten deal for Chinese citizens trying to put away money for retirement, for their children's education or other personal needs. They are given a bleak choice of subsidising the financial system through deposits yielding less than inflation or speculating on highly volatile shares.

China's financial firms are by no means model institutions either. A banking crisis, which began in the late 1990s and is still not fully resolved, cost $428 billion, according to the World Bank. In addition, billions of dollars were lost by state-controlled securities firms through unfunded “guaranteed” investment products and inept proprietary trading funded by money absconded from client accounts. China has never revealed the full cost of this disaster. Whatever the collective figure, it gives some perspective to the $335 billion or so of write-downs and credit losses thus far from the subprime crisis.

Clearly, Western banks have every reason to regret their losses. That may be one of the reasons they are not defending their methods more vigorously. Even in the West, where there is plenty of talk of regulation, they are keeping a low profile. Having got so far with China, however, bankers will be remiss if they let the misapprehensions fester. Western finance may be prone to cyclical excess, they can argue, but the state-sponsored model is even more so. At least when troubles hit Western banks, the recognition—and the healing—come far quicker.

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Buttonwood

Crude threat

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High oil prices may yet damage the global economy

Illustration by Satoshi Kambayashi

A COUPLE of years ago, those who forecast that oil would reach $100 a barrel were seen either as doomsayers or publicity-seekers. Now some are predicting $200 oil—and are taken deadly seriously.

Had economists been told that oil would barely pause at the century mark before reaching the recent peak of nearly $127, they would no doubt have forecast dire economic consequences. But the global economy, although rattled by the high price of energy, is still chugging along. Meanwhile inflation has picked up, but headline rates in most developed countries are nowhere near the levels seen in the 1970s and 1980s.

There are three explanations for the oil price's muffled impact. The first is that nowadays developed economies are more efficient in their use of energy, thanks partly to the increased importance of service industries and the diminished role of manufacturing. According to the Energy Information Administration, the energy intensity of America's GDP fell by 42% between 1980 and 2007.

A second theory is that the oil-price rise has been steady, not sudden, giving the economy time to adjust. Giovanni Serio of Goldman Sachs points out that in 1973 there was a severe supply shock because of the oil embargo, when the world had to cope with 10-15% less crude almost overnight. Not this time.

The third explanation turns the argument on its head; rather than oil harming the global economy, it is global expansion that is driving up the price of oil.

The most important factor is the shift in favour of the developing economies. America has responded to high prices in familiar fashion: UBS forecasts that demand will drop by 1.1% this year and will be no higher in 2009 than it was in 2004. But demand from China and other emerging markets is more than offsetting this shortfall. With supply growth sluggish, the steady increase in demand is hauling prices remorselessly higher. Alex Patelis of Merrill Lynch reckons it would take a recession in emerging markets to drive commodity prices substantially lower.

The best-known pessimist on the oil price's link with global growth is Andrew Oswald of the University of Warwick. In March 2000, at the height of the dotcom boom, he argued that the world economy would slow in response to higher oil prices just as it did in the 1970s, early 1980s and early 1990s. Although his argument was brushed aside at the time, there was indeed a slowdown in 2001 and 2002.

Even so, his argument looks harder to sustain this time, given that a fourfold increase in oil over the past five years has been accompanied by some fantastic global GDP growth. Mr Oswald says the problem is that the lags are long, with few effects seen for at least 12 months. It may take as long as two years before a big impact appears, he reckons, during which time higher oil prices will have pushed up business costs, leading to a decline in profits and an eventual rise in the rate of unemployment.

Perhaps that transmission mechanism has not worked quite so quickly during this cycle because companies have been benefiting from the productivity gains of their investments in technology and from their outsourcing to Asian economies. But those gains may be starting to run out: profit growth, as a share of American GDP, peaked over a year ago.

Companies are now facing a squeeze. Figures from Britain this week showed that firms had pushed up their output prices by 7.5% over the previous year but this rise, while startling enough, was nowhere near sufficient to compensate them for a 23.3% gain in raw-materials prices, the biggest since 1980.

It will be even more difficult to maintain profit margins when consumers are under pressure. Again, higher oil prices are part of the problem. Goldman Sachs reckons that some $3 trillion of wealth was transferred from oil consumers to oil producers between 2001 and 2007 and the pace of transfer is running at $1.8 trillion a year. In general, producing countries save more, and spend less, than consuming nations. At the same time, of course, falling house prices in America, Britain, Spain and Ireland threaten to make consumers feel the pinch.

Moreover, central banks may be unable to give consumers much help. With British inflation rising faster than expected, the Bank of England may join the European Central Bank, the Bank of Japan and the Federal Reserve in keeping interest rates on hold for the foreseeable future. So far oil has been the “dog that did not bark”; but it may yet give the global economy a nasty bite.

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Insurance

Another problem parent

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Is AIG the Citigroup of insurance?

MORTGAGE craters, ropy disclosure, bloated costs, a newish boss desperately trying to stop the haemorrhaging amid calls for radical surgery, even a break-up. Citigroup? Aptly though this describes America's biggest bank, it could just as easily apply to its biggest insurer, American International Group (AIG).

AIG's place in the credit crunch's hall of shame is now assured thanks to its record $7.8 billion loss in the latest quarter, bringing the red ink over the past six months to $13 billion. The main culprit is its book of credit-default swaps, much of it tied to subprime mortgages, which has been written down by $20 billion. A chastened AIG has joined the rush for fresh capital.

Disgruntled shareholders have a flag-waver in Hank Greenberg, who ran AIG imperiously for 37 years before being booted out in 2005 amid an accounting probe. Still the biggest individual shareholder, the 83-year-old lashed out at his former fief this week, averring that it had suffered a “complete loss of credibility”.

There is restiveness within, too. Executives at International Lease Finance Corporation, the world's biggest buyer of commercial aircraft and part of AIG since 1990, are reportedly agitating for a spin-off. They worry that AIG's woes will drag down ILFC: its credit rating was cut along with its parent's following the latest loss.

Such huffing is a trifle disingenuous. ILFC has benefited from being under AIG's wing, for instance amid the turmoil for aviation after September 11th 2001. And most of the dodgy default swaps were written on Mr Greenberg's watch—indeed, AIG stopped selling them at the end of 2005, a few months after he had been replaced by Martin Sullivan, a former protégé.

But AIG has played its hand badly. It insisted until this year that it had $15 billion-20 billion of excess capital and that actual (as opposed to mark-to-market) losses were unlikely. It has since retreated from that position and modified its internal models (ie, made them less optimistic). But uncertainty still abounds. AIG estimates its ultimate derivatives losses will be up to $2.4 billion. Unnervingly, an independent assessor hired by AIG puts the potential cost as high as $11 billion. AIG thinks much of the current damage will be reversed, thanks to the vagaries of fair-value accounting. But why trust its judgment rather than the market's? And any such gains won't come at least until 2009, says Thomas Cholnoky of Goldman Sachs.

Softening insurance markets may compound AIG's woes. With pricing power ebbing and catastrophe pay-outs set to rise after an unusually calm couple of years, America's property and casualty industry—dominated by AIG and Berkshire Hathaway—seems to be entering another of its periodic downturns (see chart). Premium rates in casualty will fall by 10-15% this year, predicts Lockton, a broker.

With the bull run in stocks over, life insurance and annuities could suffer, too. And insurers face lower returns on investments in alternative assets, such as hedge funds and private equity. “Yellow lights are blinking all over the industry,” says Donald Light of Celent, a consultancy.

All of which means AIG faces a double whammy of credit-market missteps and a deteriorating core business. Time is not on the affable Mr Sullivan's side. At the annual meeting this week, the directors reiterated their support for him, though some have privately begun to express doubts. Who said insurance was dull?

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The battle for deposits

Your bank needs you

May 15th 2008
From The Economist print edition

Banks want more retail funding. Easier said than done

THE humble deposit is back. Thanks to the seizure in the wholesale markets, which provided many banks with the money they needed to finance rapid growth during the boom, retail funding is again in heavy demand. In fact, deposits are not perfect either: they too can suddenly evaporate (just ask Northern Rock) and they suffer from a maturity mismatch with long-term assets such as mortgages. But that is tomorrow's headache. “Banks have rediscovered retail as a funding source,” says Dick Harryvan, the boss of ING Direct, a leading internet bank.

However, wanting more deposits is very different from winning them, let alone keeping them. The obvious way to attract new business is to jack up savings rates. Banks are certainly being more lavish than in the past. When interest rates last stood at 5% in Britain, in late 2006, the top savings rates on offer were more than one percentage point lower than today.

Many of the higher rates are being dangled by cost-effective internet operations. Kaupthing and Landsbanki, two Icelandic banks that have been trying to increase their deposit-to-loan ratios since a liquidity scare in 2006, have energetic online savings arms. For such smaller banks, even modest inflows of new deposits can make a big difference.

It is more difficult to make a substantial difference to the size of deposit bases if they are already well-developed. The back book of existing customers presents a particularly thorny problem. Allowing everyone to enjoy higher rates means cannibalising your own profits. Reserving the best rates for new customers either irritates core depositors or invites them to try and game the system. One simple savers' tactic vexing the banks is to withdraw money and then to re-deposit it in order to claim the higher rate.

Even if banks are successful in bringing new money in, two larger questions remain. The first is whether it will stay. The deposit business is largely built on the laziness of customers who keep their money in accounts no matter what the rate. Those who respond to higher rates are also the likeliest to move if a better offer comes along. ING Direct ran into this problem in Britain before the credit crisis, when a failure to keep pace with rates of other providers led to an exodus of disgruntled depositors. It now deliberately targets less rate-sensitive customers.

The second question is how much money banks can make if they are having to compete so hard to entice savers. There are ways to offset the higher costs of deposits. Some retail banks require depositors to put equal amounts of money into other, more profitable, products. Others are looking at structured accounts, where the payouts are linked to the performance of equity indices and where risks can be hedged. But such products are definitely not for the mass market: they may in fact be a route into deposit-taking for the investment banks themselves.

The shape of the yield curve (the difference between long- and short-term interest rates) also makes a difference. ING Direct announced a sharp increase in its interest margin when it released first-quarter results on May 14th, thanks largely to the recent cuts in short-term American interest rates.

But in Europe the yield curve remains inverted (see chart), which drags down profits. Mr Harryvan reckons that the start-up costs for ING Direct would be around €2 billion ($3.1 billion) in today's interest-rate environment, almost three times the actual figure five years ago. Deposits may be back in fashion, but they are not for the faddish.

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European banks

Austria 1, Germany 0

May 15th 2008 | FRANKFURT AND INNSBRUCK
From The Economist print edition

The Germans should study Austrian strategy for once

AFP

Germany's open goal

ON JUNE 16th Austria and Germany will slug it out on the football pitch, with Germany hotly tipped to win. But there is a rather bumpier playing field on which the Austrians are well ahead: banking. Austrian banks have successfully expanded into central Europe, which now accounts for around 40% of their profits, says Standard & Poor's, a rating agency. The two main domestic banking groups, the co-operative banks and the savings banks, are strengthened by a mutual support mechanism, known as a *Haftungsverbund*, which enables them to bail each other out when there are any signs of trouble. So impressed was the European Commission by this *Verbund* that it used it as a model when drawing up Europe-wide capital-adequacy laws—a triumph which Austrian savings bankers celebrated at their annual bash in Innsbruck last month.

In Germany, however, similar support schemes are not nearly as robust, partly because some of their members are reeling from their misadventures in the American mortgage market. Hardest hit are the publicly owned Landesbanks. One, SachsenLB, would have failed had it not been taken over by its bigger cousin LBBW in Stuttgart. WestLB, now on its fifth boss in three years, has required a €5 billion ($7.7 billion) guarantee from the state of North Rhine-Westphalia; and BayernLB, amid political ructions, recently needed a similar sum from its joint owners, the state of Bavaria and the local savings banks.

Landesbanks began as central banks for the savings banks in each German *Land*, or state, providing wholesale and payments services. But that role has long been redundant. To justify their existence the Landesbanks embarked on foreign adventures, using cheap state-guaranteed funding to undercut the competition. The guarantee went in 2005, prompting them to take bigger risks to stay in the game. The German savings-banks association, the DSGV, bought Landesbank Berlin Holding last year, which included the Berliner Sparkasse, a profitable savings bank, to save it from falling into private hands. But it has no interest in saving any others. “If a private investor picked up a Landesbank now, I'd be a happy man,” says Heinrich Haasis, chief executive of the DSGV.

Landesbanks are not the only hard sell. IKB Deutsche Industriebank, a listed bank which got into trouble last year, and is now owned 45% by KfW, the state development bank, has among its potential buyers WestLB and BayernLB—which is rather like drowning men trying to save each other.

Meanwhile, the German savings banks might be healthy enough at a local level. They also have mutual-protection schemes (though only one, in Hesse and Thuringia, is close to the Austrian model). But they have little prospect of growth. They cannot be sold privately. They are hampered by a “regional principle” which bars them from seeking business in each other's territory, except via the internet.

With the German publicly owned banking industry—holding just over a third of total assets—in such a bind, cross-border consolidation would make sense. The Austrian savings banks, led by their flagship Erste Bank, have no inhibitions about looking west as well as east. “We tell the Bavarians that they should join our *Haftungsverbund*,” says Michael Ikrath, secretary-general of the Austrian savings-banks association. But swapping football shirts after next month's game is probably as far as the Germans are prepared to go.

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Microfinance

Poor people, rich returns

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Is it acceptable to profit from the poor?

SINCE CompartamosBanco, a Mexican lender to the poor, went public a year or so ago, a rift has been growing in the booming microfinance industry. To supporters of traditional charitable microfinance—providing loans and other financial services to help lift people out of extreme poverty—the Compartamos initial public offering has come to symbolise an aggressive move by capitalists to profit from the poor. To its backers, on the other hand, the success of Compartamos, despite the recent lacklustre performance of its shares, symbolises how the profit motive can help lift many more people out of poverty than charity alone could ever do.

Critics of Compartamos include Muhammad Yunus, a Bangladeshi economist who won the Nobel peace prize in 2006 for his work in popularising microfinance through the Grameen Bank. He was reportedly "shocked" by the IPO, and has argued that microfinance should be about "protecting [poor people] from the moneylenders, not creating new ones." Another critic, Chuck Waterfield of Microfin, a provider of software to microfinance institutions, accuses Compartamos of "monopolistic exploitation of the poor". He alleges that it is charging interest rates of over 100% a year, little different from what illegal loan sharks demand, and that it is deliberately making it difficult for poor borrowers to understand how much they are paying for their loans. He and Mr Yunus are campaigning for the microfinance industry to agree on common standards on disclosing charges to help borrowers.

Compartamos concedes that its rates may seem high—though it reckons they are closer to 70%—but says they are set to allow the bank to grow quickly to meet vast untapped demand in Mexico. Its borrowers have risen in number from 60,000 to around 900,000 in the past eight years. This is hardly an indication of exploited customers. Moreover, it is targeting potential borrowers just outside the mainstream, not the very poorest Mexicans.

A "big win" like the Compartamos IPO was needed to attract lots more capital into the microfinance industry, says Álvaro Rodríguez Arregui, the chairman of ACCION International, a charity that has been helping to spread microfinance since the 1970s. He expects interest rates to fall sharply as the rush of capital that followed the IPO expands supply and intensifies competition—just as it has done in Bolivia, which boasts the first for-profit, but not listed, microfinance institution, BancoSol. For-profit microfinance has been growing fast, including in India where SKS, a lender created by Vikram Akula, a former McKinsey partner, is backed by Sequoia, a leading Silicon Valley venture-capital firm.

ACCION was an early investor in Compartamos, and banked $140m in the IPO (and retains a 9% stake). This infuriates critics such as Mr Waterfield, especially as ACCION has received funding from the American taxpayer via USAID, the development agency. ACCION is reinvesting the money in new microfinance schemes, however. Mr Rodríguez Arregui fears the public fight over profits may scare away investors. Perhaps the best way to help the poor is to acknowledge that charitable and commercial microfinance can co-exist.

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Mining

Sterling silver

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A Mexican IPO boosts London's status as a mining hub

IN THE hills north-east of Mexico City it is not uncommon to find Cornish pasties for sale. At least the pastry shells originated in Cornwall, but the fillings—such as chocolate-flavoured chicken *mole*—are distinctly Mexican. This is fusion cuisine from 100 years ago, the legacy of an influx of silver miners from Cornwall to this part of Mexico at the beginning of the 20th century.

This month Mexican mining moved in the opposite direction with the listing of Fresnillo, the world's largest producer of silver, on the London Stock Exchange (LSE). The company, the first Mexican one to be listed in London, raised some $2 billion, but its initial public offering had broader ramifications. You might have expected a Mexican company to head straight for Wall Street. That it did not both shows the success of the LSE's efforts in Latin America and also highlights the extent to which London now dominates mining finance.

Fresnillo is in good company, says Graham Dallas of the LSE. Four of the five largest mining companies in the world are listed in London. A decade ago, Toronto might have been their favoured destination, if it was not New York. But compared with Toronto, London has more liquidity, as well as more analysts, bankers and lawyers specialising in natural resources. Fresnillo's boss, Jaime Lomelín, says London's appeal has grown over New York because of the way it treats taxes, and because he prefers the LSE's comply-or-explain “combined code” of corporate governance to the Sarbanes-Oxley legislation in America.

Though half of its board is independent, Fresnillo's corporate governance is not pristine: it is still 75% owned by Peñoles, a larger mining company, and will be chaired by Alberto Baillères, Peñoles's boss and Mexico's second-richest man, according to *Forbes*. Critics will argue that the voluntary regulation is one reason such companies are attracted to London over New York, and regulation is a tricky business—it always looks more failsafe than it actually is.

Fresnillo is not the only Latin American firm to be seduced. Hochschild, a Peruvian mining company, went public in London in 2006. Until recently, such companies would have been considered part of New York's “backyard”—but the LSE is not respectful of boundaries. After all, mining is a global business, and you do not always need deep country-specific knowledge to understand it. That is why Cornish miners could work easily in Mexico. It is also why Mexican miners can find a home in London.

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Economics focus

Malthus, the false prophet

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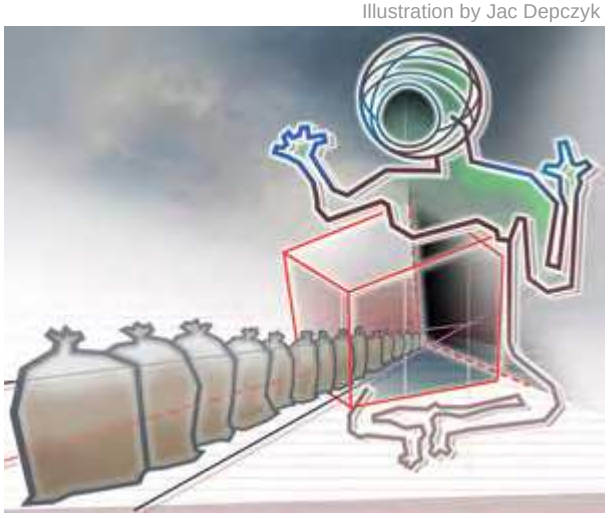
Illustration by Jac Depczyk



The pessimistic parson and early political economist remains as wrong as ever

AMID an astonishing surge in food prices, which has sparked riots and unrest in many countries and is making even the relatively affluent citizens of America and Europe feel the pinch, faith in the ability of global markets to fill nearly 7 billion bellies is dwindling. Given the fear that a new era of chronic shortages may have begun, it is perhaps understandable that the name of Thomas Malthus is in the air. Yet if his views were indeed now correct, that would defy the experience of the past two centuries.

Malthus first set out his ideas in 1798 in “An Essay on the Principle of Population”. This expounded a tragic twin trajectory for the growth of human populations and the increase of food supply. Whereas the natural tendency was for populations to grow without end, food supply would run up against the limit of finite land. As a result, the “positive checks” of higher mortality caused by famine, disease and war were necessary to bring the number of people back in line with the capacity to feed them.

In a second edition published in 1803, Malthus softened his original harsh message by introducing the idea of moral restraint. Such a “preventive check”, operating through the birth rather than the death rate, could provide a way to counter the otherwise inexorable logic of too many mouths chasing too little food. If couples married late and had fewer children, population growth could be sufficiently arrested for agriculture to cope.

It was the misfortune of Malthus—but the good luck of generations born after him—that he wrote at an historical turning point. His ideas, especially his later ones, were arguably an accurate description of pre-industrial societies, which teetered on a precarious balance between empty and full stomachs. But the industrial revolution, which had already begun in Britain, was transforming the long-term outlook for economic growth. Economies were starting to expand faster than their populations, bringing about a sustained improvement in living standards.

Far from food running out, as Malthus had feared, it became abundant as trade expanded and low-cost agricultural producers like Argentina and Australia joined the world economy. Reforms based on sound political economy played a vital role, too. In particular, the abolition of the Corn Laws in 1846 paved the way for British workers to gain from cheap food imports.

Malthus got his demographic as well as his economic predictions wrong. His assumption that populations would carry on growing in times of plenty turned out to be false. Starting in Europe, one country after another underwent a “demographic transformation” as economic development brought greater prosperity. Both birth and death rates dropped and population growth eventually started to slow.

The Malthusian heresy re-emerged in the early 1970s, the last time food prices shot up. Then, at least, there appeared to be some cause for demographic alarm. Global-population growth had picked up sharply after the second world war because it took time for high birth rates in developing countries to follow down the plunge in infant-mortality rates brought about by modern medicine. But once again the worries about overpopulation proved mistaken as the “green revolution” and further advances in agricultural efficiency boosted food supply.

If the world's population growth was a false concern four decades ago, when it peaked at 2% a year, it is even less so now that it has slowed to 1.2%. But even though crude demography is not to blame, changing lifestyles arising from rapid economic growth especially in Asia are a new worry. As the Chinese have become more affluent, they have started to consume more meat, raising the underlying demand for basic food since cattle need more grain to feed than humans. Neo-Malthusians question whether the world can provide 6.7 billion people (rising to 9.2 billion by 2050) with a Western-style diet.

Once again the gloom is overdone. There may no longer be virgin lands to be settled and cultivated, as in the 19th century, but there is no reason to believe that agricultural productivity has hit a buffer. Indeed, one of the main barriers to another “green revolution” is unwarranted popular worries about genetically modified foods, which is holding back farm output not just in Europe, but in the developing countries that could use them to boost their exports.

Political folly increases in a geometrical ratio

As so often, governments are making matters worse. Food-export bans are proliferating. Although these may produce temporary relief for any one country, the more they spread the tighter global markets become. Another wrongheaded policy has been America's subsidy to domestic ethanol production in a bid to reduce dependence on imported oil. This misconceived attempt to grow more fuel rather than to curb demand is expected to gobble up a third of this year's maize (corn) crop.

Although neo-Malthusianism naturally has much to say about food scarcity, the doctrine emerges more generally as the idea of absolute limits on resources and energy, such as the notion of “peak oil”. Following the earlier scares of the 1970s, oil companies defied the pessimists by finding extra fields, not least since higher prices had spurred new exploration. But even if oil wells were to run dry, economies can still adapt by finding and exploiting other energy sources.

A new form of Malthusian limit has more recently emerged through the need to constrain greenhouse-gas emissions in order to tackle global warming. But this too can be overcome by shifting to a low-carbon economy. As with agriculture, the main difficulty in making the necessary adjustment comes from poor policies, such as governments' reluctance to impose a carbon tax. There may be curbs on traditional forms of growth, but there is no limit to human ingenuity. That is why Malthus remains as wrong today as he was two centuries ago.

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The environment

Dead water

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AP

Too much nitrogen being washed into the sea is causing dead zones to spread alarmingly

NEW life generally flourishes in the spring, unless it is marine life in the Gulf of Mexico. Every spring the coastal waters turn into a scene of devastation and death. Known as a “dead zone”, this vast oxygen-depleted area extends along the coast between Louisiana and Texas.

Hundreds of the world's coastal regions have dead zones. They mostly occur when spring rainfall gathers on land, makes its way into streams and rivers, and eventually tumbles down to the ocean. The rivers carry with them a cargo of nutrients, in particular nitrogen, from farms in the watershed. When this nitrogen reaches the sea it causes a brief frenzy of algal growth which depletes the water of oxygen. Fish, clams, shrimp, crabs, entire mussel reefs and other bottom-dwelling animals can be wiped out.

Jane Lubchenco, a marine ecologist from Oregon State University, says this nutrient run-off from land is increasing the number, size, duration and severity of the dead zones. This is mainly because the use of fertilisers in agriculture is increasing. Sometimes the waste from animals or human sewage worsens the blight.

Nitrogen, which, makes up about 78% of the Earth's atmosphere, is an inert gas but it has more reactive forms. One of these comes from making fertilisers, using the Haber-Bosch process which converts nitrogen gas into ammonia. Although some of the fertiliser used on fields is taken up by plants and then by the animals that eat them, most of it accumulates in the soil before being washed to the coast and eventually even to the deep ocean. Another source of nitrogen pollution comes from fossil fuels, which produce nitrogen oxides when they are burnt. These oxides are released into the atmosphere and they can fall back to earth as acid rain.

The release of reactive nitrogen into the environment has a “cascade” effect, according to two papers published in the latest issue of *Science*. James Galloway of the University of Virginia, the lead author of one of the papers, says that every single atom of reactive nitrogen can cause a cascading sequence of events which can harm human health and ecosystems.

In the lower atmosphere the oxides of nitrogen add to an increase in ozone and small particles, which can cause respiratory ailments. The reactive nitrogen in acid rain kills insects and fish in rivers and lakes. And when it is carried to the coast it contributes to the formation of dead zones and in the creation of red tides (a kind of toxic, algal bloom that can form in the sea). It is then converted to nitrous oxide which adds to global warming.

According to Alan Townsend, of the University of Colorado, Boulder, humans are creating reactive nitrogen at a record pace, and moving it around the world as never before. People create about 190m

tonnes of reactive nitrogen a year, compared with 90m-120m tonnes from natural processes, such as nitrogen-fixing bacteria and lightning strikes.

Some of this man-made nitrogen helps to grow food and biofuels, but the nitrogen uptake by plants and animals is so inefficient that only 10-15% of the reactive nitrogen created for food production actually ends up being eaten as food. The rest of the nitrogen goes into the environment. What is worrying is that the production of reactive nitrogen is set to increase according to most predictions.

Doug Capone, of the University of Southern California, says that the increased levels of reactive nitrogen are now responsible for about 3% of the biological production of new marine life in the open ocean. Because there is only a limited supply of nitrogen out in the open ocean, additional amounts of it can have a huge stimulating effect.

Good but bad

This sounds like it is good news for the climate, because marine life absorbs about 10% of man-made carbon dioxide into the ocean. The more marine life there is, the more absorption. But two-thirds of this effect may be offset by the greater release of nitrous oxide, a potent greenhouse gas, from the sea.

Dr Galloway says the aim is to maximise the effectiveness of nitrogen in food production while minimising the effects on the environment and human health. There is room for improvement. Existing technology can remove nitrogen oxides when fossil fuels burn, at a cost. Breeding or genetic modification could increase the efficiency with which animals and plants take up nitrogen. Improving animal management (with better diets and use of manure), would also help. And if only half of the sewage of the 3.2 billion people living in cities were treated, the environment would be spared about 5m tonnes of reactive nitrogen a year. Altogether, such interventions would add up to about 54m tonnes of less reactive nitrogen, about 28% of what was created in 2005.

Already cap-and-trade schemes are springing up in some American watersheds because of concern about the spread of dead zones. They work in the same way as America's sulphur-dioxide trading scheme and Europe's emissions-trading scheme for carbon. Polluters trade the right to pollute with substances such as nitrogen. Although this can be cost-effective, it is likely to work only when pollutants come from identifiable sources.

Dr Galloway's next task is to create a nitrogen-footprint calculator on the internet, which would be similar to a carbon-footprint calculator.

Although there seems to be little prospect of any immediate and concerted action to try to restore the Gulf of Mexico's dead zone, the north-western coastal area of the Black Sea provides an accidental example of how some places might, if given the chance, improve very quickly. After the collapse of the centrally planned economies of eastern and central Europe, the use of manufactured fertilisers declined because they were no longer affordable. Within seven years the Black Sea's dead zone had largely vanished and fisheries had recovered. That, at least, is cause for a little spring cheer.

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Malaria

Resisting arrest

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Fighting malarial drug resistance

WILL the world lose another miracle cure? Fifty years ago chloroquine seemed to be an unbeatable malaria remedy. But as the popularity spread of this synthetic form of quinine (a tree extract), the biological backlash began in the form of drug resistance. Today it is not recommended even for use in Africa, which suffers most of the world's malarial deaths.

In the past few years artemisinin, derived from *Artemisia annua*, a bush common in China, seemed equally promising. Alarmingly, though, signs of resistance to it have started to appear in South-East Asia. A large part of the reason for the build-up of resistance is the use of the drug by itself, as a monotherapy, rather than in combination with another drug. Experts agree that the use of Artemisinin Combination Therapies (ACTs) can greatly delay drug resistance in Africa. The World Health Organisation recommends their use. The leading ACT today is Coartem, which combines artemether, a derivative of the Chinese drug, with lumifantrine, another anti-malarial remedy.

The snag is that unscrupulous manufacturers peddle substandard ACTs and monotherapies. Roger Bate, of the American Enterprise Institute and his colleagues, examined the malarial remedies sold by the private sector in six African countries. Their study, recently published in the *Public Library of Science (PLoS)*, found that many were substandard and that a third were artemisinin monotherapies. This, the researchers concluded, “places the future of malaria treatment at risk globally”.

What is to be done? Widespread testing and surveillance would help. But Ramanan Laxminarayan of Resources for the Future, a think-tank, has another idea: rather than rely on just one “front-line” therapy he argues for the use of several ACTs and points to research that suggests the use of multiple therapies can dramatically extend the useful life of artemisinin.

Something like that may yet happen. A consortium led by Farmanguinhos, a state-run drugs firm in Brazil, recently launched ASMQ, which combines artesunate, a derivative of artemisinin, with mefloquine, another anti-malarial, in a convenient single-pill that does not need refrigeration and has shown good results in field trials. The developers want it to be widely available, so they will not seek a patent.

But that does not guarantee success, says Rachel Nugent of the Centre for Global Development. As she points out,ACTs are complex and costly to develop and make. The new Brazilian pill will sell for about $2.50 per adult dose. That is cheaper than buying the drugs separately, but much more expensive than the dodgy monotherapies uncovered by the researchers. It is also pricier than Coartem, which Novartis sells for under $1 a dose.

Even so, the new ACT is welcome. Resources for the Future suggests that the benefit ASMQ will bring in delaying drug resistance will greatly outweigh its higher cost. But are people suffering from malaria now prepared to pay the price to help future generations? Dr Laxminarayan reckons governments and big donors could help by providing extra money to subsidise the widespread use of a new ACT, rather than lose another promising drug needlessly soon.

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Animal behaviour

Cheetahs of the deep

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Some whales dive deep and fast hunting their prey

EVERY ecosystem has a cast of characters playing similar roles. The bison, moose and elk of North America do much the same thing as antelope and wildebeest do on the African savannah. Jackals and hyenas are the scavengers of the land whereas vultures are the undisputed scavengers of the air. The same is even true of carnivores. Crocodiles, cheetahs, great white sharks and peregrine falcons all come at their prey with great speed, using a combination of momentum and strength to stun and kill. Now research has put up a surprising candidate to join this high-speed predatory club: the short-finned pilot whale.

Whales, like all mammals, have lungs and must rise to the surface once in a while to breathe. The problem for many whale species is that their sources of food are usually at depth, forcing them to hold their breath as they descend to feed. Researchers have long assumed that deep-diving whales conserve their oxygen supply by moving slowly, not more than 2 metres per second, during their long descents. But that is not the way of the short-finned pilot whale.

Natacha Aguilar of La Laguna University on the Spanish Canary Islands and her colleagues fitted special suction-cupped electronic tags to 23 short-finned pilot whales near Tenerife. The tags were designed by Mark Johnson of the Woods Hole Oceanographic Institution to record whale sounds while monitoring both their depth and position. The aim of the study, which will appear in a forthcoming edition of *Animal Ecology*, was to understand the foraging strategies that the whales used in deep-water.

The tags revealed that the maximum depth and time of the whales' dives was 1,018 metres and 21 minutes, which was in line with expectations. However, during most dives below 540 metres during the day, the whales broke into a sprint of up to 9 metres per second, which in deep water is the cetacean equivalent of a world record.

During these sprints the tags also picked up sonar buzzes and clicks from the whales which are known to be associated with the capture of prey. So the whales were chasing something at high speed, like a cheetah would on land. The researchers are not sure what is being hunted, but they suspect that it is large and worth the exertion in terms of the number of calories it could provide. One possibility is that the prey are giant squid: a chase of Titanic proportions.

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Mobile-phone microscopes

Doctor on call

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Simple accessories could turn mobile phones into useful medical devices

ROBI MAAMARI stares intently at the screen of his mobile phone. The student is not squinting to tap out yet another daft text message, but looking carefully for the faint blue dots that are the tell-tale diagnostic signature of malaria.

Mr Maamari is a member of a research team led by Dan Fletcher, a professor of bioengineering at the University of California, Berkeley, which has developed a cheap attachment to turn the digital camera on many of today's mobile phones into a microscope. Called a CellScope, it can show individual white and red blood cells, which means that with the correct stain it can be used to identify the parasite that causes malaria. Moreover, by transmitting an image directly over the mobile network, the CellScope could greatly help with the remote diagnosis and monitoring of many illnesses.

The project, which began as a challenge by Dr Fletcher to his undergraduate students to turn their mobile phones into microscopes, gained momentum when they came up with some practical designs. Although the first prototype covered a tabletop, the latest uses commercially available lenses fitted inside a tube that snaps directly onto the phone. One end has a clip for holding a sample slide, and different levels of magnification are possible. The team thinks the attachments, if mass-produced, could be made smaller and tougher, and sell for less than $100.

The diagnosis of malaria was the first test because it demands a high-quality image. In recent weeks the team has successfully identified its first samples. Eventually CellScope promises to extend the clinician's range. Someone with a small amount of training would be able to take and stain blood samples, and then capture and transmit images to an expert who could carry out the diagnosis.

The images also help create digital records, which would make it easier to monitor and verify the success of a drug trial or the introduction of mosquito nets in a remote area, for instance.

Not surprisingly, interest in the project is growing. Microsoft has donated some camera phones equipped with satellite-navigation devices and Nokia has been in touch. Even the research arm of America's defence department has expressed an interest. Once a final prototype is ready, it may be tested by doctors in the Philippines and Colombia.

Applications need not be confined to the developing world. Many cancer patients have to travel to a hospital each week for simple cell counts to be carried out. Dr Fletcher hopes the CellScope may enable them to do this from home. Also, farmers who suffer crop blight could send images from plant samples for remote diagnosis by agricultural experts. The Berkeley team is working on this idea with the University of Florida, which runs a remote diagnostics programme for farmers.

Another group of bioengineers at Berkeley is looking at other ways to use mobile phones in medicine. Boris Rubinsky and his colleagues think they could help make medical imagining simpler, cheaper and more widely available. His team report in a recent issue of *Public Library of Science (PloS) ONE* on a design to use mobile phones to send raw imaging data to a base where it could be processed with the sophisticated software needed to create a medical image. The image could then be returned to the mobile phone and viewed on it. The mobile phone may join the stethoscope and the thermometer as an indispensable piece of medical kit.

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LED street lights

No smoke or mirrors

May 15th 2008 | DUSSELDORF
From The Economist print edition

Replacing gas lamps with LEDs

DUSSELDORF is not well-endowed with nostalgic charm, and soon may be shorter of it still. The 17,000 or so gas lamps that still bathe the streets of the old centre in their glow are on their way out. The German city's municipal power utility plans to replace about 10,000 of them with a technology that is cheaper to operate but so modern that only a handful of cities have begun to use it: light-emitting diodes (LEDs).

So far, only two dozen experimental LED street lamps have been put up in Dusseldorf. Although LEDs can initially be more expensive, they are a lot more reliable and they can last longer than conventional light bulbs.

But LEDs do have drawbacks. The utility reckons that in terms of the total amount of light produced from a watt of electricity, LEDs still do not match fluorescent or sodium lamps. But that will change in coming years as LEDs improve. Anyway, the light from LEDs can be used more efficiently than that from conventional lamps, reckons Ulrich Kuipers, from the South Westfalia University of Applied Sciences, which developed the Dusseldorf lamps. “You can direct LED light very well,” he says. So instead of casting light all around—often over places that do not need to be illuminated, each LED is directed much like a spotlight.

But not everyone is happy. Many people think the white light from the LEDs is too cold. “It's true, I made a mistake there,” admits Mr Kuipers. So he now plans to use another useful characteristic of LEDs—their ability to produce different colours and hues. That way he hopes to imitate the friendly glow of old gas lamps.

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Global warming

A lot of hot air

May 15th 2008
From The Economist print edition

AFP

Books about climate change are often flawed—some more so than others

ONE of the most troubling aspects of climate change is the feedback loop. As the world warms, so frozen earth begins to melt, which releases greenhouse gases, which warms the world up further. Something similar seems to be happening with the literature of climate change. As people write books on global warming, so they generate interest in the subject, which increases demand, which leads to the writing of even more books. Both these cycles result in a lot of hot air.

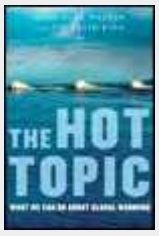
Looking at four recent books, one can observe another familiar dynamic: as quantity increases, so quality declines. Earlier climate-change books were written mostly by unimportant obsessives. This crop is mostly written by important people whose co-writers presumably did much of the legwork. Some of the books suffer accordingly.

Sir David King is an important person. He was the British government's chief scientific adviser until 2007, and was instrumental in pushing Britain to take more seriously than any other nation Europe's attempts to cut the continent's carbon emissions and to commit itself to further, more ambitious, national targets.

Sir David's is the layman's handbook. It will not be regarded as an important step in the field of climate-change literature. It is a competent summary of where the subject has got to, in terms of science, government policy and business, and will be quite handy for those who need to mug up on sustainability for tomorrow's board meeting. Anybody looking for anything that engages the imagination, however, need not trouble themselves with it.

Fred Krupp is also an important person. He runs the Environmental Defence Fund (EDF), which invented the cap-and-trade system for cutting carbon emissions. The mechanism involves putting a cap on overall emissions and allows companies to buy and sell emissions reductions, so that the cheapest cuts get made first. The EDF suggested this in the 1990s as a way of cutting sulphur-dioxide emissions from power stations. It worked; the idea spread. At America's insistence and in the face of European reluctance, it was incorporated into the Kyoto protocol. America then walked away from Kyoto, but Europe introduced cap-and-trade in 2005 and the next American president is likely to adopt it.

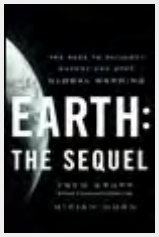
The Hot Topic: What We Can Do About Global Warming
By Gabrielle Walker and Sir David King



Harcourt; 276 pages; $14.
Bloomsbury; £9.99

Buy it at
Amazon.com
Amazon.co.uk

Earth: The Sequel—The Race to Reinvent Energy and Stop Global Warming
By Fred Krupp and Miriam Horn



Norton; 279 pages; $24.95

Mr Krupp's book is the businessman's guide. It starts from a promising point; if cap-and-trade is widely adopted, cleaner energy technologies will be in demand, so those who develop them will be the next energy billionaires.

The book explains those technologies through the people trying to bring them to market. Some of the details are nice, such as the work of scientists trying to create enzymes to do the difficult job of breaking cellulose down to make ethanol. They go round collecting “extremophiles”—bacteria that can do tough jobs in difficult circumstances—from volcanoes and deep-sea vents. But the book is a tiring list with no narrative or analytical structure. And it is not helped by the silly title: “Earth: The Sequel”. The battle is to preserve the current planet, not to move on to the next one.

Nigel Lawson is another important person. Margaret Thatcher famously called him her “brilliant chancellor” shortly before a painful recession that was caused in part by his monetary policy. Lord Lawson's offering is the refusenik's book. He is one of the few remaining serious people who argue against the current consensus on global warming. The resulting slim volume, produced without the aid of a co-writer, is clear, analytical and compelling: it has all the virtues of a book written by a very clever, very cross man.

It does, however, have shortcomings. Lord Lawson sets up straw men (“it is popularly supposed by politicians and the media”), credits them with beliefs that nobody serious holds (“that the sole cause of global warming is the growth in man-made carbon-dioxide emissions”), then knocks them down. He relies on old evidence to attack the consensus (such as an apparent disparity between temperatures on the earth's surface and in the troposphere, which was resolved two years ago).

There is also something peculiar in the book's argument. The policy conclusion of the consensus against which Lord Lawson rails is that the world needs a carbon tax or cap-and-trade system to reduce greenhouse-gas emissions. Having marshalled some powerful (though ultimately unconvincing) arguments against such measures, Lord Lawson suddenly announces: “I believe the case can be made for the introduction of an across-the-board carbon tax,” on the grounds that “if people like to feel that they are helping to save the planet by paying a carbon tax, they should not be deprived of the opportunity to do so.” But if Lord Lawson thinks people are wrong to believe that they should pay a carbon tax in order to save the planet, why doesn't he argue against it? And if he doesn't argue against it, why has he bothered to write this book?

Wallace Broecker is not as important as the other authors, but he is well-known in the surprisingly gripping field of palaeoclimatology. He has spent his career investigating the climate in prehistoric times and, in particular, the role that the oceans have played in the way it changed.

His book is the oddest, and the nicest, of the bunch. He is clearly a rather delightful man, with a penchant for practical jokes; through his life-story, the book explains how scientists have come to understand the history of the world's climate. That helps illuminate the future. Knowing that sea levels have varied by more than 100 metres in the past, as ice-sheets have melted and re-formed, lends a certain weight to the argument that serious climate change is best avoided.

In this case the presence of a co-writer adds to the charm of the story, for Robert Kunzig seems to have fallen for Mr Broecker and his world. It is easy to see why. Palaeoclimatology is full of people obsessing about fabulously obscure wrinkles in the climate's history, and investigating them by drilling cores thousands of metres into the Arctic ice, or counting the oxygen atoms in minuscule foraminifer shells to learn just when the world froze and warmed: “the planet in a grain of sand”, says Mr Kunzig, who has a lovely appreciation of the poetry of science. Buy this one. Forget the rest.

The Hot Topic: What We Can Do About Global Warming.
By Gabrielle Walker and Sir David King.
Harcourt; 276 page; $14. Bloomsbury; £9.99

Buy it at
Amazon.com
Amazon.co.uk

An Appeal to Reason: A Cool Look at Global Warming
By Nigel Lawson

Duckworth Overlook; 149 pages; $19.95 and £9.99

Buy it at
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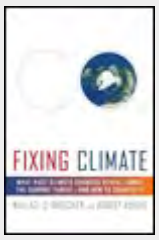
Fixing Climate: What Past Climate Changes Reveal About the Current Threat—and How to Counter It
By Wallace S. Broecker and Robert Kunzig



Hill and Wang; 272 pages; $25. Profile/Sort of Books; £10.99

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Abu Ghraib

Tortured truth

May 15th 2008
From The Economist print edition

“I DON'T give a fuck what you do to him,” the Army Criminal Investigation Command (CID) agent told the American guards at Abu Ghraib as he handed the new Iraqi prisoner over to them. “Just don't kill him.” The photo (below) of the detainee, hooded, draped in a blanket, and perched on a box with electric wires attached to outstretched hands, was to become the most recognised emblem of America's “war on terror” after the twin towers—a symbol of America's own humiliation and disgrace.

“There was no way to misinterpret those photos,” Joe Darby, the soldier who turned them in to his superiors, insisted: “The truth was in the pictures.” In fact, it wasn't, indeed far from it, as Philip Gourevitch, a journalist, prize-winning author and now editor of the *Paris Review*, and Errol Morris, a film-maker, demonstrate in this fascinating book (and in a film of the same name, which won the Grand Jury prize at the Berlin film festival in February), based on hundreds of hours of interviews with the main characters involved.

AP

Standing joke

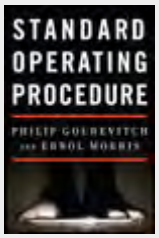
A picture may be said to be worth a thousand words, but unless its context is known, it is also easy to misinterpret. That is why the authors decided not to include in their book any of the notorious photos of detainee abuse taken by a group of military police (MP) on the nightshift of Abu Ghraib's main interrogation block over the last three months of 2003. What most mattered at the prison, Mr Gourevitch says, was never photographed, while too much was often read into events that were.

Take the “mock-electrocution” photo. The prisoner, suspected of killing a CID agent, would normally have been kept naked, as were most prisoners awaiting interrogation at Abu Ghraib. But in the cold autumnal air, a guard took pity on him, draping him in a prison blanket. The wires, which had been tested to ensure they were not live, were attached to his hands as a gag. True, one of the guards had jokingly told the prisoner he might get electrocuted if he fell off the box, but no one was sure he really believed it. The whole session lasted no more than ten minutes or so, just long enough to take a few souvenir photos.

Conditions at Abu Ghraib were terrible, for both guards and prisoners. Hooding, shackling, sleep deprivation, nakedness, stress positions, forced physical exercises—these had all become part of the “standard operating procedure” at the prison long before the snap-happy MPs arrived. Beyond a single sheet of paper, the guards, most of them reservists trained for combat, with no experience of prison duty, were never given any written rules. Nor did they have any training in the Geneva Conventions. Not that it would have done much good if they had, for they were told that the protections afforded by those conventions did not apply to the “security detainees” they were holding.

The guards' orders were to “soften up” the detainees prior to interrogation. If anyone ever queried what was going on, he was simply told he should do whatever the interrogators asked him to do. Any attempt to report abuse to senior officers was ignored or rebuffed. No one was ever reprimanded. Although most

Standard Operating Procedure
By Philip Gourevitch and Errol Morris



Penguin Press; 286 pages; $25.95. Picador; £16.99

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Amazon.co.uk

of the guards probably knew what they were doing was morally wrong, if not illegal, they came to regard it as the “norm”—part of their duty to help save American lives. Had not the vice-president himself, Dick Cheney, spoken soon after the September 2001 attacks on America of the need to start working on “the dark side”? The posed “fun” bits were caught on camera; the more serious stuff, the beatings, punchings and even killings, were not.

Only around a dozen soldiers were convicted for the abuse depicted in the Abu Ghraib photos. The highest ranking was a corporal. No interrogator was even prosecuted, though most of the techniques had been learnt from them. A general and a few other officers got reprimands and demotions. But as this book makes clear, those higher up the line of command—up to and including people in the White House—must at least have known, if not ordered, what went on.

Standard Operating Procedure.
By Philip Gourevitch and Errol Morris.
Penguin Press; 286 pages; $25.95. Picador; £16.99

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Britain and Europe

At loggerheads

May 15th 2008
From The Economist print edition

THE tale of Britain and Europe is like an unhappy marriage. Britain was late to the altar, joining the European Economic Community only in 1973, by when the terms of the relationship had been fixed. All governments since have complained, so that Britain is now the bad boy of Europe. Yet, as in many unhappy marriages, nobody has the guts to call it a day.

For 20 years Sir Stephen Wall had an insider's feel for this relationship, in the Foreign Office, in Brussels and as Tony Blair's European Union adviser in Number Ten Downing Street. His book is not a memoir, but it relates in gory detail the European experience of three prime ministers—Margaret Thatcher, John Major and Mr Blair—with their rows about the European budget, mad-cow disease, the single currency and new European treaties.

Two failings stand out. One is that British governments never mastered the trick played so deftly by others of dressing up their own national interest as if it were Europe's. The second is that most portrayed the European game largely in zero-sum terms, in which either Brussels or Britain wins but never both. The classic case was the 1992 Maastricht treaty, which the Major government quite wrongly called “game, set and match” for Britain.

As one would expect, Sir Stephen is a reliable guide, though not above trivial errors (Sir Donald Maitland was permanent representative in Brussels when Margaret Thatcher came to power, not Sir Michael Butler; Ken Clarke was home secretary, not chancellor, during Black Wednesday in 1992; Luxembourg failed to settle the EU budget in 2005, not 2004). It is a diplomat's tale, written by somebody who freely admits that some of the happiest hours of his life have been spent in the Justus Lipsius building of the Council of the European Union in Brussels.

The book makes clear two important things about today's EU. First, it pervades almost every corner of public policy. New parliamentarians and ministers are often taken aback by how much of their work involves Brussels—and by how little they know of the EU's methods. Second is the importance of heads of government in the European Council, now the club's dominant policymaking body. That puts its direction in the hands notably of Number Ten, the Elysée in Paris and the federal chancellery in Berlin—which is why direct personal involvement by national leaders counts more than ever.

Anand Menon, professor of West European politics at Britain's University of Birmingham, makes a similar point about the growing weight of the European Council—which is why the choice of a first permanent president for this body later this year will matter. His book is, in essence, a potted history of what he calls Europe's unlovable union. He points up common themes around the continent: for example, European issues are second-order in national and even European elections, and all governments delight in blaming Brussels for failure and taking credit for any success.

Mr Menon's book has more on economics and competition than Sir Stephen's, even if it lacks an insider's edge. The European project marked its 50th birthday last year with the usual mid-life crisis, but it has proved a permanent (and sometimes useful) feature of world politics. Indeed, it would be good if the Tory leader, David Cameron, took time out to read both these books. If he ever gets to Number Ten, Europe would be a huge issue—one he seems quite unprepared for.

A Stranger in Europe: Britain and the EU from Thatcher to Blair
By Stephen Wall

Oxford University Press; 230 pages; $39.95 and £20

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Europe: The State of the Union
By Anand Menon

Atlantic Books; 290 pages; £16.99

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Secrets of leadership

Smartly does it

May 15th 2008
From The Economist print edition

SHOULD a leader strive to be loved or feared? This question, famously posed by Machiavelli, lies at the heart of Joseph Nye's new book. Mr Nye, a former dean of the Kennedy School of Government at Harvard and one-time chairman of America's National Intelligence Council, is best known for promoting the idea of "soft power", based on persuasion and influence, as a counterpoint to "hard power", based on coercion and force.

Having analysed the use of soft and hard power in politics and diplomacy in his previous books, he has now turned his attention to the relationship between power and leadership, in both the political and business spheres. Machiavelli, he notes, concluded that "one ought to be both feared and loved, but as it is difficult for the two to go together, it is much safer to be feared than loved." In short, hard power is preferable to soft power. But modern leadership theorists have come to the opposite conclusion.

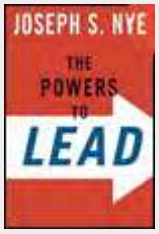
The context of leadership is changing, they observe, and the historical emphasis on hard power is becoming outdated. In modern companies and democracies, power is increasingly diffused and traditional hierarchies are being undermined, making soft power ever more important. But that does not mean coercion should now take a back seat to persuasion, Mr Nye argues. Instead, he advocates a synthesis of these two views. The conclusion of "The Powers to Lead", his survey of the theory of leadership, is that a combination of hard and soft power, which he calls "smart power", is the best approach.

The dominant theoretical model of leadership at the moment is, apparently, the "neocharismatic and transformational leadership paradigm". Anyone allergic to management jargon will already be running for the exit, but Mr Nye has performed a valuable service in rounding up and summarising the various academic studies and theories of leadership into a single, slim volume. He examines different approaches to leadership, the morality of leadership and how the wider context can determine the effectiveness of a particular leader. There are plenty of anecdotes and examples, both historical and contemporary, political and corporate.

Alas, leadership is a slippery subject, and as he rehearses the pros and cons of various theories, even Mr Nye never quite nails the jelly to the wall. He is at his most interesting when discussing the moral aspects of leadership—in particular, the question of whether it is sometimes necessary for good leaders to lie—and he provides a helpful 12-point summary of his conclusions. A recurring theme is that as circumstances change, different sorts of leaders are required; a leader who thrives in one environment may struggle in another, and vice versa. Ultimately that is just a fancy way of saying that leadership offers no easy answers.

The Powers to Lead.
By Joseph S. Nye.
Oxford University Press; 226 pages; $21.95 and £11.99

The Powers to Lead
By Joseph S. Nye



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Jewellery on show

Baubles and bling

May 15th 2008
From The Economist print edition

The V&A's new jewellery gallery has much to show off about

PATRICIA GOLDSTEIN, a small, feisty New Yorker, was 15 years old when she bought her first piece of jewellery, a Victorian locket. By the late 1960s Goldstein had become a dealer. She made regular buying trips to Europe, and never passed through London without visiting the Victoria & Albert (V&A) museum's jewellery gallery where, she recalled, she would “wander for an hour or two in blissful serenity”. Then, in 2001, recently widowed and terminally ill, the childless 71-year-old told the museum she was bequeathing it her treasures.

On May 24th the V&A's jewellery gallery will reopen after a four-year restoration. Some 3,500 jewels will be on display, some of them dating back to the Middle Ages. There are diamonds that once sparkled on the gowns of Empresses Catherine the Great and Josephine. There are also 120 of Goldstein's modern pieces, including a pair of gold dress clips made in the 1940s by Paul Flato, a Hollywood favourite with a surreal streak. Each clip is a human footprint topped by five ruby toes.

The restoration has been paid for by William and Judith Bollinger, financiers and collectors. Their £7m ($14m) gift enabled the V&A to commission Eva Jiricna, a London architect, to redesign the space and Beatriz Chadour-Sampson, a jewellery consultant, to work on the displays. Only the best of what was previously on show has been kept, including the 400 finest rings. Many of the displays are new, including Goldstein's legacy. Judith Siegel, another American, has given more than a dozen pieces by Fortunato Pio Castellani, a 19th-century Italian jeweller, and his pupil and later competitor, Carlo Giuliano. The Bollingers have lent three pieces of their own: thistle-inspired jewels by René Lalique, the father of modern jewellery.

Ms Jiricna's eye-popping, blue-lit, glass spiral staircase connects the main hall with a new mezzanine floor. Running down the centre of the main gallery are a series of undulating, curved display cabinets each with a futuristic, swooping top. The effect is at once delightful and overwhelming. But the jewels are more than a match for Ms Jiricna's razzle-dazzle. Among the collection's star pieces are the “Shannongrove Gorget”, a gold Celtic collar made around 700BC, and the 16th-century “Armada Jewel”—a pendant given by Queen Elizabeth I to her privy counsellor after the defeat of the Spanish Armada.

Ms Chadour-Sampson traces different themes within a broadly chronological display. Throughout history the landmarks of life—birth, love, marriage and death—have been commemorated with jewellery. In the last cabinet a dazzling postscript illustrates the allure of rocks with a spiral-shaped display of the 183 gemstone rings that were given to the museum in 1869 by the Reverend Chauncey Hare Townshend, a Victorian poet.

The mezzanine floor contains the museum's collection of small gold boxes and watches, as well as its “regional jewellery”, silver that often used to be sniffily referred to as peasant jewellery. On the same floor computers await on chic, glossy black stands. The idea is that visitors can design their own rings—choosing stones and setting, and e-mailing the result home or to whomever needs a hint.

But the most exciting development for jewellery lovers may be the new online catalogue, which will be ready later this year. All 3,500 pieces will be here, sometimes seen from two or three angles. The V&A's jewellery has long been one of the museum's most popular displays. Ms Jiricna's new treasure trove, the 21st-century's answer to Dresden's Baroque Green Vault, will only make it more so.

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Barbara Walters

Working girl

May 15th 2008
From The Economist print edition

IN 1964 NBC's “Today” show suddenly needed a new girl. The programme always had a glamorous “girl” to handle the weather and lighter stories, but the previous one was addicted to prescription drugs and the one before her had a drink problem. “Why not Barbara?” asked Hugh Downs, the show's host, referring to Barbara Walters, the programme's lone female writer. She wasn't beautiful or well known, but she knew the ropes and would “work cheap”.

“Well, like the ingénue in a corny movie, there I was: the patient and long overlooked understudy,” writes Ms Walters in her candid new memoir, “Audition”. Having toiled in the shadows for years, writing scripts and making coffee, she finally got her big on-air break. Don Hewitt, a TV producer, had assured her she would never make it because she had the wrong looks and couldn't pronounce her “r”s properly. Ms Walters duly avoided sentences with a lot of “r”s in them.

Audition: A Memoir
By Barbara Walters

Knopf; 624 pages; $29.95

Buy it at
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Amazon.co.uk

NBC's 13-week contract turned into 13 years at “Today” and nearly half a century in front of the camera, breaking gender barriers and securing interviews when other journalists were turned down. Her genial, empathetic style won fans and friends. “Barbara, are you hungry?” Fidel Castro asked after a marathon interview in Cuba before whipping up a sandwich. Anwar Sadat's grieving widow admitted, “you were the only one I was ever jealous of because Anwar liked you so much.” Ms Walters earned a reputation for finding something soft in her subjects. “Asking the right questions has always been less important than listening to the answers,” she explains.

She helped support her family (her father was an unlucky nightclub impresario), and she remains haunted by her impatience with her disabled sister. Her insecurities—some of them financial—pushed her to work harder. “Make no mistake: television is a demanding business...it is hell on your social and romantic life,” she writes.

Indeed, Ms Walters's entertaining tome, which picks up considerably after the first 75 pages, describes three failed marriages, many complicated love affairs (including with Alan Greenspan and Edward W. Brooke, a senator) and a tough stretch with her adopted daughter. But the author seems reconciled with her many memories, and proud of her stories. It is for good reason that she now owns a ring inscribed with the words, “I did that already”.

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By Barbara Walters.
Knopf; 624 pages; $29.95

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Mildred Loving

May 15th 2008
From The Economist print edition

AP

Mildred Loving, law-changer, died on May 2nd, aged 68

THEY loved each other. That must have been why they decided to get their marriage certificate framed and to hang it up in the bedroom of their house. There was little else in the bedroom, save the bed. Certainly nothing worth locking the front door for on a warm July night in 1958 in Central Point, Virginia. No one came this way, ten miles off the Richmond Turnpike into the dipping hills and the small, poor, scattered farmhouses, unless they had to. But Mildred Loving was suddenly woken to the crash of a door and a torch levelled in her eyes.

All the law enforcement of Caroline county stood round the bed: Sheriff Garnett Brooks, his deputy and the jailer, with guns at their belts. They might have caught them in the act. But as it was, the Lovings were asleep. All the men saw was her black head on the pillow, next to his.

She didn't even think of it as a Negro head, especially. Her hair could easily set straight or wavy. That was because she had Indian blood, Cherokee from her father and Rappahannock from her mother, as well as black. All colours of people lived in Central Point, blacks with milky skin and whites with tight brown curls, who all passed the same days feeding chickens or smelling tobacco leaves drying, and who all had to use different counters from pure whites when they ate lunch in Bowling Green. They got along. If there was any race Mrs Loving considered herself, it was Indian, like Princess Pocahontas. And Pocahontas had married a white man.

The sheriff asked her husband: “What are you doing in bed with this lady?” Richard Loving didn't answer. He never said much for himself, being just a country bricklayer with a single year of high school behind him. Mrs Loving had known him since she was 11 and he was 17, a gangly white boy who took her out for years and did the decent thing when he got her pregnant, by asking her to marry him. She thought he might have known that their marriage was illegal—a strange marriage, driving 80 miles to Washington, DC, to be married almost secretly by a pastor who wasn't theirs, just picked out of the telephone book, and then driving back again. But they hadn't talked about legalities. She felt lucky just to have him.

She told the sheriff, “I'm his wife.” And Mr Loving, roused at last, pointed to the framed certificate above the bed. “That's no good here,” Sheriff Brooks said.

Mrs Loving had said the wrong thing. Had they just been going together, black and white, no one would have cared much. But they had formalised their love, and had the paperwork. This meant that under Virginia law they were cohabiting “against the peace and dignity of the Commonwealth”. It was a felony for blacks and whites to marry, and another felony to leave Virginia to do so. Fifteen other states had

similar laws. The Lovings had to get up and go to jail. “The Lord made sparrows and robins, not to mix with one another,” as Sheriff Brooks said later.

In separate cars

Faced with a year in jail or exile, they chose to go to Washington for 25 years. Mrs Loving hated it. She was “crying the blues all the time,” missing Central Point, despite the fact that they would slip back there in separate cars, first she and the children, then Richard, casually strolling from opposite directions to meet and embrace in the twilight. Only Sheriff Brooks cared that they were married, and they avoided him.

But Mrs Loving wanted to return for good. When the Civil Rights Act was being debated in 1963, she wrote to Robert Kennedy, the attorney-general, to ask whether the prospective law would make it easier for her to go home. He told her it wouldn't, but that she should ask the American Civil Liberties Union to take on her case. Within a year or so, two clever New York lawyers were working free for the Lovings. By 1967 they had obtained a unanimous ruling from Earl Warren's Supreme Court that marriage was “one of the basic civil rights of man”, which “cannot be infringed by the state”. The Lovings were free to go home and live together, in a new cinder-block house Richard built himself.

The constitutional arguments had meant nothing to them. Their chief lawyer, Bernard Cohen, had based his case in the end on the equal-rights clause of the 14th amendment, and was keen that the Lovings should listen to him speak. But they did not attend the hearings or read the decision. Richard merely urged Mr Cohen, “Tell the court I love my wife.” For Mildred, all that mattered was being able to walk down the street, in view of everyone, with her husband's arm around her. It was very simple. If she had helped many others do the same, so much the better.

She had never been an activist, and never became one. When June 12th, the day of the ruling, was proclaimed “Loving Day” as an unofficial celebration of interracial couples—who still make up only 4% of marriages in America—she produced a statement, but she was never a public figure. She lived quietly in Caroline county, as before. Her widowhood was long, after Richard was killed in a car accident in 1975, but she never thought of replacing him. They loved each other.

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Correction: Albert Hofmann

May 15th 2008
From The Economist print edition

Our Contents box last week in some editions referred to Albert Hofmann, the father of LSD, as German. He was, of course, Swiss. Our apologies.

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Overview

May 15th 2008
From The Economist print edition

Consumer prices in **America** rose by 0.2% in April, a smaller increase than expected. Prices excluding food and energy rose by 0.1%. The value of retail sales fell by 0.2% in April, mostly because of a fall in car purchases. Sales excluding cars rose by 0.5%.

In the **euro area** GDP increased by 0.7% in the first quarter, leaving it 1.9% higher than a year earlier. GDP in Germany went up by a remarkable 1.5%; in France it rose by 0.6%. Spain's GDP rose by 0.3%, the smallest quarterly increase in more than a decade.

Consumer prices in **China** rose by 8.5% in the year to April, a bit faster than in the year to March. In response to the figures, the People's Bank of China lifted the share of deposits that commercial banks must keep as reserves from 16% to 16.5%. It was the fourth time this year that the central bank had raised reserve requirements to cool the economy. Industrial production rose by 15.7% in the year to April, down from a 17.8% increase in the year to March.

Consumer-price inflation in **Britain** jumped from 2.5% to 3% in April, leaving it further adrift of the government's 2% target. In its quarterly *Inflation Report*, the Bank of England said that inflation was likely to be above 3% for much of the next year. The report dampened hopes of further interest-rate cuts. Britain's unemployment rate was stable, at 5.2%, in the three months to March.

Sweden's consumer-price inflation was 3.4% in April, unchanged from March.

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Output, prices and jobs

May 15th 2008
From The Economist print edition

Output, prices and jobs

% change on year ago

	Gross domestic product				Industrial production	Consumer prices			Unemployment
	latest	qtr*	2008†	2009†	latest	latest	year ago	2008†	rate‡, %
United States	+2.5 Q1	+0.6	+1.1	+1.7	+1.6 Mar	+3.9 Apr	+2.6	+3.5	5.0 Apr
Japan	+2.0 Q4	+3.5	+1.3	+1.5	−0.4 Mar	+1.2 Mar	−0.1	+0.9	3.8 Mar
China	+10.6 Q1	na	+9.6	+9.0	+15.7 Apr	+8.5 Apr	+3.0	+5.9	9.5 2007
Britain	+2.5 Q1	+1.6	+1.7	+1.7	+0.2 Mar	+3.0 Apr§	+2.8	+2.6	5.2 Mar††
Canada	+2.9 Q4	+0.8	+1.4	+2.1	−2.9 Feb	+1.4 Mar	+2.3	+1.8	6.1 Apr
Euro area	+2.2 Q1	+2.8	+1.6	+1.5	+2.0 Mar	+3.3 Apr	+1.9	+3.0	7.1 Mar
Austria	+3.5 Q1	+3.2	+2.3	+2.3	+4.7 Feb	+3.3 Apr	+1.8	+2.3	4.1 Mar
Belgium	+2.1 Q1	+1.6	+1.7	+1.7	+5.7 Feb	+4.2 Apr	+1.8	+2.9	10.3 Mar‡‡
France	+2.2 Q1	+2.6	+1.5	+1.5	+1.0 Mar	+3.0 Apr	+1.3	+2.7	7.5 Q4§§
Germany	+1.8 Q1	+6.1	+1.7	+1.6	+4.6 Mar	+2.4 Apr	+2.1	+2.6	7.9 Apr
Greece	+3.6 Q1	na	+2.6	+3.1	−5.4 Mar	+4.4 Apr	+2.5	+3.9	8.0 Feb
Italy	+1.9 Q3	+1.7	+0.6	+1.0	−2.5 Mar	+3.3 Apr	+1.5	+2.8	6.0 Q4
Netherlands	+3.1 Q1	+1.0	+2.5	+1.9	−0.6 Mar	+2.0 Apr	+1.8	+2.3	4.0 Mar††
Spain	+2.7 Q1	+1.2	+2.2	+1.8	−13.3 Mar	+4.2 Apr	+2.4	+3.6	9.3 Mar
Czech Republic	+5.4 Q1	na	+4.7	+5.4	−2.1 Mar	+6.8 Apr	+2.5	+6.3	5.2 Apr
Denmark	+1.9 Q4	+1.2	+1.5	+1.6	−2.5 Mar	+3.2 Apr	+1.7	+2.9	1.9 Mar
Hungary	+1.6 Q1	na	+2.4	+3.6	+4.3 Mar	+6.6 Apr	+8.8	+5.9	8.0 Mar††
Norway	+4.7 Q4	+5.2	+2.9	+2.5	+4.0 Mar	+3.1 Apr	+0.3	+3.6	2.4 Feb***
Poland	+6.1 Q4	na	+5.1	+4.3	+0.9 Mar	+4.0 Apr	+2.3	+4.0	10.5 Apr‡‡
Russia	+8.0 Q1	na	+7.1	+6.2	+6.5 Mar	+13.3 Mar	+7.4	+13.0	6.4 Mar‡‡
Sweden	+2.8 Q4	+3.1	+2.3	+2.1	+0.8 Mar	+3.4 Apr	+1.9	+3.0	6.3 Mar‡‡
Switzerland	+3.6 Q4	+4.2	+2.1	+1.7	+9.1 Q4	+2.3 Apr	+0.5	+2.0	2.6 Apr
Turkey	+3.4 Q4	na	+4.1	+5.2	+2.4 Mar	+9.7 Apr	+10.7	+9.0	11.6 Q1‡‡
Australia	+3.9 Q4	+2.4	+3.0	+2.9	+0.1 Q4	+4.2 Q1	+2.4	+3.5	4.2 Apr
Hong Kong	+6.7 Q4	+6.6	+4.9	+5.6	−0.3 Q4	+4.2 Mar	+2.4	+4.3	3.4 Mar††
India	+8.4 Q4	na	+7.8	+7.2	+3.0 Mar	+7.9 Mar	+6.7	+5.8	7.2 2007
Indonesia	+6.3 Q1	na	+5.9	+6.2	+7.5 Feb	+9.0 Apr	+6.3	+7.8	9.1 Dec
Malaysia	+7.3 Q4	na	+5.8	+5.8	+3.0 Mar	+2.8 Mar	+1.5	+2.8	3.0 Q4
Pakistan	+7.0 2007**	na	+5.0	+5.3	+8.7 Jan	+17.2 Apr	+6.9	+9.4	6.2 2006
Singapore	+7.2 Q1	+16.9	+4.5	+5.0	+16.9 Mar	+6.7 Mar	+0.7	+4.3	2.0 Q1
South Korea	+5.7 Q1	+2.9	+4.5	+4.3	+10.0 Mar	+4.1 Apr	+2.5	+2.9	3.2 Apr
Taiwan	+6.4 Q4	na	+4.3	+4.3	+8.2 Mar	+3.9 Apr	+0.7	+2.6	3.9 Mar
Thailand	+6.0 Q1	na	+4.7	+4.3	+10.1 Mar	+6.2 Apr	+1.8	+5.0	1.5 Feb
Argentina	+9.1 Q4	+8.0	+6.2	+4.5	+5.2 Mar	+8.9 Apr	+8.9	+10.3	7.5 Q4‡‡
Brazil	+6.2 Q4	+6.6	+4.6	+4.0	+1.2 Mar	+5.0 Apr	+3.0	+5.1	8.6 Mar‡‡
Chile	+4.0 Q4	+3.7	+3.6	+3.4	−1.0 Mar	+8.3 Apr	+2.5	+6.7	7.6 Mar††††
Colombia	+8.1 Q4	+6.8	+5.0	+4.5	+8.8 Feb	+5.7 Apr	+6.3	+5.5	11.1 Mar‡‡
Mexico	+3.8 Q4	+3.0	+2.1	+2.5	+5.4 Feb	+4.6 Apr	+4.0	+4.3	3.8 Mar‡‡
Venezuela	+8.5 Q4	na	+6.0	+4.5	+2.5 Jan	+29.3 Apr	+19.4	+28.2	8.2 Q1‡‡
Egypt	+8.1 Q4	na	+7.0	+6.8	+7.5 2007**	+16.4 Apr	+11.7	+10.9	9.0 Q4‡‡
Israel	+6.8 Q4	+6.4	+3.6	+3.9	+3.8 Feb	+3.7 Mar	−0.9	+3.4	6.8 Q4
Saudi Arabia	+3.5 2007	na	+6.0	+5.6	na	+9.6 Mar	+2.9	+8.5	na
South Africa	+4.6 Q4	+5.3	+4.1	+4.8	−1.1 Mar	+10.6 Mar	+6.1	+7.5	23.0 Sep‡‡
MORE COUNTRIES Data for the countries below are not provided in printed editions of *The Economist*									
Estonia	+0.4 Q1	+7.8	+2.8	+3.7	−4.9 Mar	+11.4 Apr	+5.5	+9.3	5.3 Feb
Finland	+3.7 Q4	+3.8	+2.7	+2.7	+2.5 Mar	+3.5 Apr	+2.6	+3.0	6.2 Mar
Iceland	+4.6 Q4	+1.4	+1.4	+2.6	+0.4 2007	+11.8 Apr	+5.3	+7.5	1.0 Mar‡‡
Ireland	+3.5 Q4	−3.3	+2.4	+2.4	+7.0 Mar	+4.3 Apr	+5.1	+3.0	5.5 Apr
Latvia	+3.6 Q1	na	+4.0	+4.2	−5.5 Mar	+17.5 Apr	+8.9	+13.2	4.9 Mar
Lithuania	+6.4 Q1	−0.8	+5.8	+5.5	na	+11.7 Apr	+4.8	+8.8	4.7 Mar‡‡
Luxembourg	+5.6 Q3	+2.8	+4.7	+4.8	−0.2 Feb	+3.5 Mar	+2.1	+3.7	4.2 Mar‡‡
New Zealand	+2.8 Q4	+3.1	+1.7	+2.3	+4.2 Q4	+3.4 Q1	+2.5	+3.2	3.6 Q1
Peru	+5.6 Mar	na	+7.5	+6.4	+6.4 Mar	+5.5 Apr	−0.1	+4.8	8.0 Mar‡‡
Philippines	+7.3 Q4	+7.4	+5.4	+5.5	+0.5 Jan	+8.3 Apr	+2.3	+5.8	7.4 Q1‡‡
Portugal	+0.9 Q1	−0.8	+1.5	+1.6	+6.9 Mar	+2.5 Apr	+2.7	+2.4	7.8 Q4‡‡
Slovakia	+8.7 Q1	na	+7.5	+5.7	+1.8 Mar	+4.2 Apr	+2.7	+3.5	7.6 Mar‡‡
Slovenia	+4.7 Q4	na	+4.5	+4.0	+1.0 Mar	+6.5 Apr	+2.6	+5.2	7.1 Feb‡‡

*% change on previous quarter, annual rate. †*The Economist* poll or Economist Intelligence Unit estimate/forecast. ‡National definitions. §RPI inflation rate 4.2% in Apr. **Year ending June. ††Latest three months. ‡‡Not seasonally adjusted. §§New series. ***Centred 3-month average

Sources: National statistics offices and central banks; Thomson Datastream; Reuters; Centre for Monitoring Indian Economy; OECD; ECB

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The Economist commodity-price index

May 15th 2008
From The Economist print edition

The Economist commodity-price index

2000=100

	May 6th	May 13th*	% change on one month	% change on one year
Dollar index				
All items	255.4	257.6	−1.9	+26.1
Food	251.5	256.7	−1.7	+58.7
Industrials				
All	260.3	258.7	−2.2	−0.2
Nfa†	193.3	197.4	+1.8	+24.0
Metals	296.9	292.3	−3.6	−6.9
Sterling index				
All items	195.9	200.7	−1.1	+28.6
Euro index				
All items	151.8	153.8	+0.1	+10.7
Gold				
$ per oz	879.60	868.50	−6.4	+29.1
West Texas Intermediate				
$ per barrel	121.84	125.87	+10.6	+99.8

*Provisional †Non-food agriculturals.

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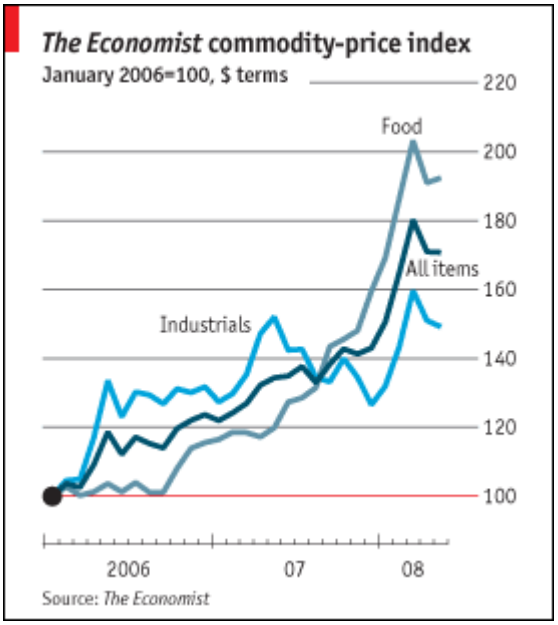
The Economist commodity-price index

May 15th 2008
From The Economist print edition

The oil price is reaching fresh highs, but other commodity prices have softened. *The Economist*'s all-items dollar index has fallen by 5% since its peak on March 4th. This drop may reflect selling by speculators as stockmarkets, and latterly the dollar itself, have staged a rally. Even food prices have dropped. America's Department of Agriculture has forecast a record world wheat harvest for the season starting in September, and prices are down by a third from their peak. But maize prices hit a new high, partly because of a projected increase in ethanol production. The metals index is 9% below its peak of a year ago. Supply fears have pushed tin prices to record levels, but nickel and zinc prices have fallen by almost half.



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Trade, exchange rates, budget balances and interest rates

May 15th 2008
From The Economist print edition

Trade, exchange rates, budget balances and interest rates

	Trade balance* latest 12 months, $bn	Current-account balance latest 12 months, $bn	Current-account balance % of GDP 2008†	Currency units, per $ May 14th	Currency units, per $ year ago	Budget balance % of GDP 2008†	Interest rates, % 3-month latest	Interest rates, % 10-year gov't bonds, latest
United States	−823.8 Mar	−738.6 Q4	−4.6	–	–	−2.4	1.96	3.93
Japan	+102.8 Mar	+216.6 Mar	+4.7	105	121	−2.9	0.75	1.67
China	+256.5 Apr	+249.9 2006	+10.5	7.00	7.68	0.5	4.49	4.36
Britain	−179.7 Mar	−115.4 Q4	−4.0	0.52	0.50	−3.2	5.80	4.81
Canada	+46.2 Mar	+12.5 Q4	−0.1	1.00	1.10	0.4	2.69	3.70
Euro area	+27.3 Feb	+25.3 Feb	−0.1	0.65	0.74	−0.8	4.86	4.09
Austria	+1.0 Feb	+12.2 Q4	+3.0	0.65	0.74	−0.4	4.86	4.35
Belgium	+15.4 Jan	+2.7 Dec	+2.1	0.65	0.74	−0.4	4.92	4.48
France	−59.3 Mar	−35.7 Mar	−1.7	0.65	0.74	−2.9	4.86	4.38
Germany	+273.9 Mar	+264.5 Mar	+6.2	0.65	0.74	1.0	4.86	4.17
Greece	−59.4 Feb	−43.8 Feb	−12.0	0.65	0.74	−2.6	4.86	4.55
Italy	−12.1 Feb	−53.4 Feb	−2.5	0.65	0.74	−2.6	4.86	4.68
Netherlands	+57.3 Mar	+50.7 Q4	+6.3	0.65	0.74	0.6	4.86	4.38
Spain	−142.5 Feb	−150.3 Feb	−9.2	0.65	0.74	−0.7	4.86	4.45
Czech Republic	+4.4 Mar	−4.7 Mar	−2.9	16.2	20.7	−2.5	4.14	4.60
Denmark	+4.1 Mar	+4.1 Mar	+0.9	4.83	5.49	3.6	5.25	4.38
Hungary	+0.2 Mar	−6.9 Q4	−5.9	162	184	−4.1	8.49	8.25
Norway	+66.9 Apr	+64.1 Q4	+17.2	5.08	6.01	17.5	6.51	4.51
Poland	−13.5 Feb	−17.2 Feb	−4.0	2.19	2.80	−2.0	6.41	6.08
Russia	+152.9 Mar	+92.4 Q1	+5.4	23.9	25.8	2.5	10.50	6.58
Sweden	+19.3 Mar	+38.1 Q4	+7.2	6.02	6.77	2.4	4.03	4.12
Switzerland	+12.5 Mar	+71.1 Q4	+14.9	1.06	1.22	0.9	2.78	3.01
Turkey	−66.8 Mar	−40.4 Mar	−6.1	1.25	1.33	−2.0	17.61	6.24‡
Australia	−21.9 Mar	−56.4 Q4	−5.9	1.07	1.21	1.5	7.80	6.26
Hong Kong	−25.0 Mar	+27.4 Q4	+9.5	7.80	7.82	3.0	1.89	2.71
India	−77.7 Mar	−12.8 Q4	−2.4	42.4	40.8	−3.1	7.29	8.26
Indonesia	+39.8 Mar	+11.0 Q4	+2.1	9,295	8,805	−1.9	8.36	7.02‡
Malaysia	+31.5 Mar	+28.9 Q4	+12.5	3.27	3.40	−3.1	3.62	4.12‡
Pakistan	−17.8 Mar	−8.4 Q4	−8.2	68.8	60.7	−5.2	10.60	9.89‡
Singapore	+32.0 Mar	+39.1 Q4	+24.4	1.38	1.52	1.0	1.39	2.41
South Korea	+6.0 Apr	+2.5 Mar	+0.3	1,047	924	0.2	5.35	5.39
Taiwan	+13.1 Apr	+31.7 Q4	+5.3	31.0	33.4	−1.8	2.70	2.58
Thailand	+8.8 Mar	+13.3 Mar	+2.1	32.5	34.6	−3.0	3.30	4.41
Argentina	+12.0 Mar	+7.3 Q4	+2.8	3.16	3.07	1.1	13.25	na
Brazil	+31.7 Apr	−9.5 Mar	−0.8	1.66	1.96	−1.8	11.62	6.16‡
Chile	+22.2 Apr	+7.2 Q4	+2.6	468	517	7.0	6.48	4.43‡
Colombia	−0.2 Feb	−5.9 Q4	−3.5	1,789	1,997	−1.7	9.25	5.59‡
Mexico	−12.2 Mar	−7.4 Q4	−1.2	10.5	10.8	nil	7.44	8.01
Venezuela	+23.7 Q4	+20.0 Q4	+7.0	3.53	4.23§	nil	14.08	6.55‡
Egypt	−20.5 Q4	+0.5 Q4	+0.3	5.36	5.69	−7.2	5.87	4.78‡
Israel	−12.4 Apr	+5.0 Q4	+1.5	3.42	3.94	−1.4	2.96	5.49
Saudi Arabia	+150.8 2007	+95.0 2007	+27.7	3.75	3.75	17.9	2.27	na
South Africa	−10.6 Mar	−20.6 Q4	−7.8	7.63	6.95	0.4	12.05	9.43
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*							
Estonia	−4.4 Feb	−3.5 Feb	−12.7	10.1	11.5	0.2	6.32	na
Finland	+12.6 Feb	+12.4 Feb	+4.1	0.65	0.74	4.6	4.70	4.34
Iceland	−1.6 nil	−3.2 Q4	−12.0	78.9	62.9	1.4	15.69	na
Ireland	+37.0 Feb	−12.7 Q4	−4.3	0.65	0.74	−0.8	4.86	4.49
Latvia	−7.3 Mar	−6.3 Feb	−14.5	0.45	0.51	nil	5.27	na
Lithuania	−7.8 Mar	−5.8 Mar	−11.5	2.23	2.54	−0.7	5.18	na
Luxembourg	−6.1 Feb	+3.9 Q4	na	0.65	0.74	1.2	4.86	na
New Zealand	−3.4 Mar	−10.2 Q4	−7.3	1.31	1.36	3.1	7.25	6.35
Peru	+8.3 Mar	+1.5 Q4	+0.4	2.76	3.17	1.6	5.50	na
Philippines	−6.5 Feb	+6.4 Dec	+4.0	42.9	47.0	−0.1	6.50	na
Portugal	−28.4 Feb	−23.4 Feb	−8.3	0.65	0.74	−2.5	4.86	4.59
Slovakia	−0.6 Mar	−4.5 Jan	−3.3	20.5	24.9	−2.1	3.95	4.53
Slovenia	−3.3 Mar	−2.6 Feb	−2.5	0.65	0.74	−0.2	na	na

*Merchandise trade only. †*The Economist* poll or Economist Intelligence Unit forecast. ‡Dollar-denominated bonds. §Unofficial exchange rate.
Sources: National statistics offices and central banks; Thomson Datastream; Reuters; JPMorgan; Bank Leumi le-Israel; Centre for Monitoring Indian Economy; Danske Bank; Hong Kong Monetary Authority; Standard Bank Group; UBS; Westpac.

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Markets

May 15th 2008
From The Economist print edition

Markets

	Index May 14th	% change on one week	% change on Dec 31st 2007 in local currency	% change on Dec 31st 2007 in $ terms
United States (DJIA)	12,898.4	+0.7	−2.8	−2.8
United States (S&P 500)	1,408.7	+1.2	−4.1	−4.1
United States (NAScomp)	2,496.7	+2.4	−5.9	−5.9
Japan (Nikkei 225)	14,118.6	+0.1	−7.8	−2.1
Japan (Topix)	1,373.0	−1.5	−7.0	−1.2
China (SSEA)	3,837.7	+2.2	−30.5	−27.5
China (SSEB, $ terms)	259.4	+2.5	−32.0	−29.1
Britain (FTSE 100)	6,216.0	−0.7	−3.7	−6.1
Canada (S&P TSX)	14,626.3	+1.8	+5.7	+4.1
Euro area (FTSE Euro 100)	1,219.1	−0.2	−11.4	−6.3
Euro area (DJ STOXX 50)	3,857.5	−0.4	−12.3	−7.3
Austria (ATX)	4,402.7	+0.7	−2.4	+3.1
Belgium (Bel 20)	3,831.7	−1.9	−7.2	−1.9
France (CAC 40)	5,055.2	−0.4	−10.0	−4.8
Germany (DAX)*	7,083.2	+0.1	−12.2	−7.2
Greece (Athex Comp)	4,276.6	+0.4	−17.4	−12.7
Italy (S&P/MIB)	34,270.0	−0.8	−11.1	−6.0
Netherlands (AEX)	488.4	+0.6	−5.3	+0.1
Spain (Madrid SE)	1,522.3	+1.0	−7.3	−2.0
Czech Republic (PX)	1,655.2	−0.5	−8.8	+2.6
Denmark (OMXCB)	422.2	+2.6	−5.9	−0.6
Hungary (BUX)	23,507.9	+1.4	−10.4	−4.1
Norway (OSEAX)	566.2	+0.7	−0.7	+6.2
Poland (WIG)	48,321.4	+0.1	−13.2	−2.6
Russia (RTS, $ terms)	2,406.1	+9.3	+2.3	+5.0
Sweden (Aff.Gen)	317.3	−0.5	−6.8	nil
Switzerland (SMI)	7,594.6	−0.6	−10.5	−4.0
Turkey (ISE)	42,522.7	−1.7	−23.4	−28.3
Australia (All Ord.)	5,940.3	+3.2	−7.5	−1.4
Hong Kong (Hang Seng)	25,533.5	−0.3	−8.2	−8.2
India (BSE)	16,978.4	−2.1	−16.3	−22.3
Indonesia (JSX)	2,449.3	+2.8	−10.8	−9.9
Malaysia (KLSE)	1,287.7	nil	−10.9	−9.8
Pakistan (KSE)	14,593.4	+1.0	+3.7	−7.1
Singapore (STI)	3,198.5	−0.9	−7.7	−3.6
South Korea (KOSPI)	1,843.8	−0.6	−2.8	−13.1
Taiwan (TWI)	9,018.4	+1.0	+6.0	+10.8
Thailand (SET)	848.9	nil	−1.1	+2.6
Argentina (MERV)	2,088.8	−0.2	−2.9	−3.2
Brazil (BVSP)	70,026.0	+1.5	+9.6	+17.4
Chile (IGPA)	13,694.9	−0.5	−2.7	+3.4
Colombia (IGBC)	10,210.9	+1.0	−4.5	+7.6
Mexico (IPC)	31,336.6	+1.9	+6.1	+10.4
Venezuela (IBC)	36,407.2	−4.4	−3.9	−41.6
Egypt (Case 30)	10,665.8	−8.8	+1.9	+4.9
Israel (TA-100)	1,028.1	+1.9	−11.0	+0.1
Saudi Arabia (Tadawul)	9,783.2	+0.1	+23.3	+23.3
South Africa (JSE AS)	32,387.0	+1.5	+11.8	+0.2
Europe (FTSEurofirst 300)	1,354.7	−0.5	−10.1	−4.9
World, dev'd (MSCI)	1,530.8	+0.5	−3.7	−3.7
Emerging markets (MSCI)	1,207.6	+0.1	−3.1	−3.1
World, all (MSCI)	388.8	+0.5	−3.6	−3.6
World bonds (Citigroup)	766.8	−0.1	+5.0	+5.0
EMBI+ (JPMorgan)	440.3	−0.4	+1.6	+1.6
Hedge funds (HFRX)	1,319.8	+0.3	−0.7	−0.7
Volatility, US (VIX)	22.5	21.6	22.5	(levels)
CDSs, Eur (iTRAXX)†	68.5	+1.0	+35.3	+43.1
CDSs, N Am (CDX)†	97.8	−8.1	+11.7	+11.7
Carbon trading (EU ETS) €	24.5	−2.4	+10.0	+16.3

*Total return index. †Credit-default swap spreads, basis points.

Sources: National statistics offices, central banks and stock exchanges; Thomson Datastream; Reuters; WM/Reuters; JPMorgan Chase; Bank Leumi le-Israel; CBOE; CME; Danske Bank; EEX; HKMA; Markit; Standard Bank Group; UBS; Westpac.

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Hedge-fund performance

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The rewards for hedge-fund investors have been far from spectacular since the beginning of last year, according to the Hedge Fund Research index, an industry benchmark. Funds still open to new investment yielded just 3.1% between January 2007 and the beginning of May this year, scarcely more than the return from investing in a standard global-equity fund. Rich-world corporate bonds outperformed both equity markets and hedge funds in terms of dollar returns. But one attraction of hedge-fund investments is that, as a class, they have been much less volatile than either bonds or equities. In the early months of this year, when stockmarkets slumped, hedge-fund returns held up fairly well.

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